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ERISA and the challenges of using ESG in retirement plan investing

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For retirement plans, including private company retirement plans regulated by the Employee Retirement Income Security Act of 1974 (ERISA), employers often ask about whether they can give consideration to "environmental, social, or governance" (ESG) factors when selecting investment options. In part, this interest can be driven by corporate ESG goals or by the interest of employees (or other stakeholders), or a combination of both.

The answer to the question of whether ERISA permits consideration of ESG is yes — but only if the application complies with ERISA's fiduciary standards. Those fiduciary standards require that ESG investing by retirement plans be made through a prudent process and in accordance with the employees' retirement investing interests. This means that employers cannot blindly use ESG. Instead, ERISA's fiduciary standards must be considered.

Adding to the challenge of this issue is that for the last 25 years the primary regulator of those standards, the U.S. Department of Labor (DOL), has provided conflicting guidance on how to apply ERISA's fiduciary standards to ESG. This regulatory back-and-forth has been particularly hot in the last two years as the Trump and Biden administrations have staked out different positions through DOL action.

For these reasons, it can be helpful for employers and retirement plan fiduciaries to understand the ERISA issues created by using ESG criteria in selecting and managing retirement plan investments, including why this remains an area of changing legal standards, especially in the last few years.

Background

Broadly speaking, in the retirement plan context ESG investing refers to the consideration of factors related to the environment (such as a company's record on pollution and sustainability), social goals (such as supporting unions or divesting from certain industries), or corporate governance (such as company and board diversity). Employers and plan fiduciaries can evaluate ESG in any number of ways. For example, retirement plans can invest in (or offer investment in, in the case of a 401(k) plan) "ESG specific" funds.

Plans can also apply ESG screening criteria to avoid investments that do not meet certain ESG standards. Retirement plans can also apply ESG indirectly. For example, plan fiduciaries can apply ESG considerations as just one type of financial evaluation criteria among many others (such as risk, cost, and expected performance). In addition, even if employers are not directly considering ESG, the underlying managers of plan investment funds and options may be using ESG factors, even if the investment is not an ESG-themed fund.

Legal issues raised under ERISA

ERISA is the primary law that sets out the legal duties that apply when a private employer selects investment options for a retirement plan that covers its employees. ERISA does not apply to government plans, but state and local laws often incorporate ERISA's standards.

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Under ERISA, parties that are fiduciaries to a retirement plan (such as the employer or third-party managers) are required to make investment decisions through a prudent process and with loyalty to the interests of the plan and its participants. These twin duties are referred to as ERISA's fiduciary duties broadly, and specifically as the duty of prudence and the duty of loyalty. The second duty (the duty of loyalty) requires a singular concern for the interests of the retirement plan and the employees participating in it.

The primary regulator of these two fiduciary duties (the DOL) has consistently taken a position that these duties require that ESG criteria can only be applied to retirement plan investing if the criteria otherwise meet these duties of prudence and loyalty, i.e., as part of a prudent process and to support the retirement income interests of the plan's participants. Under this framework, an ERISA fiduciary could risk violating ERISA if he or she used ESG solely to achieve a political or social outcome without demonstrating that the criteria were part of an appropriate investment process and based on the best interests of the employees in the plan.

When applying ESG factors, the second duty (the duty of loyalty) can raise particularly hard questions because employers can struggle to

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distinguish ESG factors that support retirement savings from those that are ancillary and outside the employees' "best" interests.

A classic example of this is where a fiduciary for a union retirement plan directs the plan to invest in assets that support the union. For example, there have been a number of cases involving union plans investing in real property owned by the union, investing in a construction project that uses union labor, or buying investments from a union-owned bank. In those cases, courts and the DOL frequently — although not always — view this "social" investing as contrary to ERISA's duty of loyalty because although the investment may benefit the union and/or its members, the benefit does not directly relate to retirement savings.

While there appears to be both increasing corporate and employee focus on ESG goals, ESG investing, or some combination of both, employers cannot satisfy this interest by applying ESG considerations blindly to retirement plans.

Another example is applying an environmental criterion, such as not investing a retirement plan in stocks of companies with poor environmental records. Using these types of investing "screens" could violate ERISA's duty of loyalty if the screen is based only on a pro-environmental goal. Similarly, applying diversity criteria (such as not investing in companies that fail diversity standards or have a known track record of discrimination or harassment) could be contrary to ERISA's loyalty standard if the investment choice is made only to support diversity or to not enable discrimination/harassment.

At the same time, these same ESG factors can, depending upon the facts and circumstances, be applied in a manner that supports the participants' retirement income interests. There is a body of academic and investment literature that accepts the use of ESG factors as material investment criteria. In this framework, the ESG factor can have a material impact on an investment's risk, return or other material financial consideration. For example, through this lens, a company's poor environmental record could be economically relevant if it is a sign of future liability. Similarly, poor corporate governance could have a material impact on future stock performance.

Thus, as these examples demonstrate, ESG factors can be both consistent and inconsistent with ERISA's fiduciary duties, depending in part on the surrounding facts and circumstances.

DOL conflicting guidance

Adding to the challenge is that over the last 25 years, the DOL has taken different positions on how to interpret this framework and, specifically, how to distinguish ESG usage that is material to retirement investment versus ancillary. During Democratic administrations, the DOL generally views ESG as not inconsistent with ERISA's fiduciary duties and as capable of being applied in a manner that is loyal to ERISA plan interests. Conversely, the DOL under Republican administrations has been more resistant to ESG as an appropriate investment factor and, especially, more cautious that such factors can be used without violating ERISA's duties, especially the duty of loyalty.

Under the Trump administration, the Trump DOL released a regulation that imposed new standards on ESG usage by ERISA plans. Many ERISA professionals viewed the rule as creating some challenges for using ESG criteria. During 2020, the DOL conducted enforcement examinations of ERISA plans on their use of ESG, thus reinforcing the risks of using ESG criteria in ERISA-regulated plans.

Under the Biden administration, the DOL is in the process of reproposing the Trump-era ESG rule. While the Biden rule is expected to be more pro-ESG, the fundamental framework of ERISA's duties will remain and will likely continue to warrant care in applying ESG to retirement plan investment.

Employers should take care to comply with ERISA when applying ESG

Employers that seek to consider ESG when engaging in retirement plan investing may continue to face compliance questions. While ERISA does not preclude application of ESG criteria, employers that want to apply ESG criteria will need to ensure that such application complies with ERISA's fiduciary duties. This is true even where there is strong company or employee interest in ESG matters. While there appears to be both increasing corporate and employee focus on ESG goals, ESG investing, or some combination of both, employers cannot satisfy this interest by applying ESG considerations blindly to retirement plans. Instead, ERISA's fiduciary standards must be considered.

In particular, employers should confirm that ESG criteria is applied through an appropriate investment process and driven by the employees' best interests regarding retirement. Finally, this area will likely continue to be subject to DOL guidance, including the current Biden administration's effort to reinterpret regulations applicable to ESG through the DOL.

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