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ERISA Considerations In A Dynamic ESG Landscape

By **Elizabeth Goldberg and Rachel Mann** (March 7, 2023, 5:10 PM EST)

Elizabeth Goldberg

Rachel Mann

Both the U.S. House of Representatives and the Senate on Feb. 28 and March 1, respectively, passed a resolution to overturn the U.S. Department of Labor's so-called ESG rule,[1] which has been a topic of fierce debate as it seeks to clarify the role that environmental, social and governance factors can play in fiduciary decision making on behalf of retirement plans regulated by the Employee Retirement Income Security Act of 1974.[2]

This resolution is part of a larger effort to limit ESG investing at both federal and state levels.[3]

The ESG rule, released in its final form in November, provides ERISA-regulated fiduciaries greater flexibility and leeway to consider ESG factors, and explicitly allows for the consideration of certain ESG factors that are financially relevant to an investment's risk-return analysis.[4]

But recent congressional, judicial and state legislative developments have complicated the landscape surrounding ESG investing and underscore the care and diligence that fiduciaries should undertake when considering ESG factors as part of their investment decision making on behalf of a plan.

These new laws and court challenges are unlikely to ban ESG disclosures entirely — rather, they will likely serve to hone fiduciary focus on how to consider and, as appropriate, incorporate ESG factors into the ERISA investment decision-making process.

Congress

The House and Senate voted to overturn the ESG rule via the Congressional Review Act, or CRA, which allows Congress to repeal a final rule issued by a federal agency within 60 legislative days of its going into effect by a simple majority in both chambers. The majority of the ESG rule's provisions went into effect on Jan. 30.

The resolution passed the House with a party-line vote of 216-204, with only one Democrat crossing the aisle, and by a slim majority in the Senate, 50-46, with two Democrats voting to overturn.

President Joe Biden has already declared that he will veto the CRA resolution, marking the first use of his veto power since taking office in January 2021.

While this attempt to overturn the ESG rule will likely be unsuccessful, it's not the only challenge the rule faces.

Courts

In the last month, multiple plaintiffs have filed two separate lawsuits seeking to block the Labor Department from enforcing the ESG rule, alleging that it politicizes the retirement system by allowing consideration of ESG factors — which they claim may be tied to politically or ethically motivated goals — in fiduciary decision making.

The first lawsuit, Utah v. Walsh, was filed in late January in the U.S. District Court for the Northern District of Texas.[5] The Utah plaintiffs, a coalition of attorneys general from 25 states and three additional private plaintiffs, allege that the rule oversteps the Labor Department's authority and is arbitrary and capricious under the Administrative Procedure Act.

Braun v. Walsh, the second lawsuit, was filed in late February in the U.S. District Court for the Eastern District of Wisconsin.[6] The two Braun plaintiffs, both of whom are participants in ERISA-regulated retirement plans, argue that the rule violates ERISA and exceeds the statutory authority granted to the U.S. secretary of labor.

States

Additionally, since the start of the 2023 legislative session in mid-January, 26 states have proposed their own versions of ESG investing rules, 23 of which seek to limit or restrict the consideration of ESG factors by state funds and/or their fiduciaries, in direct contrast to the ESG rule.

Fourteen states already enacted similarly restrictive rules in 2021 and 2022.[7]

These state rules do not outright ban the consideration of ESG factors, but instead, they regulate ESG investing by mandating that fiduciaries or companies only consider the relevant factors for financial, rather than social or ethical, reasons.

ERISA preempts these state rules as applied to employer-sponsored retirement plans, but these developments speak to the broader climate surrounding ESG investing.[8]

Implications

This regulatory dynamism underscores why it is important for fiduciaries to carefully ponder the role, if any, that ESG considerations play in their investment decisions.

The CRA resolution, the federal lawsuits and the state regulations would not result in outright bans on the consideration of ESG factors in investing writ large, but their ultimate focus is on limiting the reasons why fiduciaries and companies may consider certain ESG factors.

Viewed through that lens, the ESG rule and these challenges are not necessarily at direct odds with one another.

Rather, these legislative and judicial developments underscore the importance of ensuring that any ESG usage is carefully implemented to ensure compliance with the applicable legal regime, be it ERISA or state law.

Practical Considerations for ERISA Fiduciaries

While ERISA fiduciaries may be feeling whiplash as a result of this regulatory tug-of-war over ESG, this complicated and evolving landscape has not banned — and is unlikely to ban — any consideration of ESG in ERISA plans.

Moreover, the current landscape will not change ERISA's long-standing principles of a fiduciary's duty of loyalty and prudence, as well as the importance of process in meeting those duties.

Instead, the broader landscape underscores that fiduciaries should be careful in ESG usage and that such usage should be based on a cautious and appropriate process. The ESG rule can still provide a starting point and guide rails for that process.

In this climate, this type of careful process could include evaluating whether to consider the role of ESG in an ERISA plan, keeping in mind that ESG usage can be indirect, such as underlying asset manager ESG usage or using ESG as one investment factor among many others.

From that evaluation, fiduciaries can seek to update governance materials — e.g., investment policy statements and committee meeting materials — as appropriate to reflect the intended role of ESG in the plan.

This type of due diligence and process can provide the building blocks to creating a process that satisfies ERISA's long-standing principles of duty of loyalty and prudence, and withstands challenges as the ESG landscape continues to evolve and intensify.

Elizabeth Goldberg is a partner and Rachel Mann is an associate at Morgan Lewis & Bockius LLP.

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[1] https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.

[2] https://www.morganlewis.com/pubs/2022/10/money-or-ethics-the-esg-investing-debate-hedge-fund-law-report.

[3] https://www.morganlewis.com/pubs/2023/01/esg-investing-legislation-predictions-for-the-2023-2024-legislative-session.

[4] https://www.morganlewis.com/blogs/mlbenebits/2022/11/us-department-of-labor-gives-a-green-thumbs-up-to-esg; https://www.morganlewis.com/pubs/2022/11/dol-reframes-esg-investing-and-proxy-voting-for-erisa-fiduciaries.

[5] https://aboutblaw.com/6xO.

[6] https://assets.law360news.com/1578000/1578700/https-ecf-wied-uscourts-gov-doc1-20315125534.pdf.

[7] https://www.morganlewis.com/pubs/2023/01/esg-investing-legislation-predictions-for-the-2023-2024-legislative-session.

[8] https://www.morganlewis.com/-/media/files/publication/outside-publication/article/2022/anti-esg-bills-raise-questions-for-public-retirement-plans-law360.pdf.