IGNITES

26 States in Uphill Battle to Overturn DOL's ESG Rule

A district court in September sided with the Department of Labor, but the states appealed the decision in a case that is now unfolding in the 5th Circuit.

By Sabrina Kharrazi | April 19, 2024

A group of state attorneys general face long odds in attempting to overturn the **Department of Labor**'s 2022 rule governing the consideration of environmental, social, and governance factors in selecting investments for 401(k) plans, industry lawyers said.

Shortly before the rule went into effect in February, attorneys general filed suit with the goal of axing the regulation.

They alleged that the agency acted in violation of the Employee Retirement Income Security Act by promoting considerations for choosing plan investments that are outside of financial gain, and that the rule is "arbitrary and capricious," running afoul of the Administrative Procedure Act.

In September, a federal district court ruled that the DOL's rule that allows — but doesn't require — plan fiduciaries to consider ESG factors in choosing investments wasn't "manifestly contrary" to Erisa.

The attorneys general immediately appealed that decision in the 5th Circuit Court.

They said the lower court erred with the decision, particularly with respect to the rule's guidance around seemingly rare tiebreaker scenarios where all other relevant investment assessments are equal, except the ESG factors, according to the plaintiffs' brief filed Jan. 18.

A spokesperson for Utah Attorney General Sean Reyes didn't respond to requests for comment about the litigation.

Reyes and his office have represented the group in the litigation.

The attorneys general face a high burden in demonstrating the DOL's rule as arbitrary, capricious or an abuse of discretion, according to **William Pollak**, counsel at **O'Melveny**, who isn't involved in the case.

"Particularly when you have the similarities between the prior [Trump administration] rule and this rule in the tiebreaker provisions, it makes it very hard to show that it's an arbitrary and capricious change," Pollak said.

The DOL's 2022 ESG rule replaced one that the Trump administration passed in 2020.

Agency officials announced in March 2021 that they wouldn't enforce the 2020 rule, citing confusion among investors as to whether ESG factors could be treated as "pecuniary" factors, or factors that can have a material impact on the risk and return of an investment.

A few weeks after the attorneys general filed suit in January 2023, two 401(k) plan participants in Wisconsin also brought a lawsuit against the DOL over the ESG rule. They also argued that the regulation exceeded the department's authority and violated Erisa's standard of only considering pecuniary factors in a fiduciary's investment decisions.

The plan participants also contended that the tiebreaker portion of the rule was problematic.

They said that ambiguity resulting from the DOL's language around evaluating two otherwise equal investments based on their value to the plan "over the appropriate time horizon" left room for arbitrary and unregulated consideration of ESG in investment decisions, their court filings state.

The plaintiffs are participants in retirement plans sponsored by **SWAT Environmental** and **Petron Corporation**.

Along with their February complaint, the plaintiffs in the Wisconsin suit sought a preliminary injunction, which would pause the rule.

The judge hearing the case issued an order that froze filing deadlines until the court issues a ruling on the injunction request, which is still pending, court documents show.

Litigation in that suit is "slightly behind" the proceedings in the 5th Circuit and could likely be informed by the outcome in the appellate court's proceedings, Pollak said.

A key argument in both suits involves the 2022 amendments' removal of language used in the 2020 version of the rule that mandated more stringent requirements around detailing the specific scenarios that merit ESG considerations in a tiebreaker, according to that complaint.

In the case before the 5th Circuit, the DOL argued in March that in the few instances where two investments are tied, it may not be in the financial interest of a fiduciary to choose both, which is what the plaintiffs suggested. The DOL also contended that tiebreaker scenarios are rare because liquid and well-functioning markets generally prevent them from happening.

Tiebreaker scenarios invoke questions around duty of loyalty for plan fiduciaries, and violations of that duty are "very hard to prove," according to **Michael Barry**, a senior consultant at **October Three Consulting**.

"I don't think courts are going to be comfortable saying, 'We're going to punish that guy for breaching the duty of loyalty,'" he said. "As long as your investments are adequately diversified, identifying a duty of loyalty issue is getting into mind reading."

On March 28, Arizona, California and Pennsylvania joined 17 other states to file a letter of support for the DOL in the case now before the 5th Circuit.

"The 2022 rule supports amici's [the 20 states] interests by ensuring that plan fiduciaries may consider all relevant factors to minimize risk and maximize returns," the letter reads.

The **American Retirement Association** also filed a letter in support of the DOL rule, court filings show.

Conversely, the **National Federation of Independent Business Small Business Legal Center** and the **Texas Public Policy Foundation** were among those who submitted letters in support of the attorneys general's appeal.

"This has been a game of regulatory ping-pong at the Erisa level, first with sub-regulatory guidance, then with the proposed rules and finalized rules in 2020, and then again in 2022," said **Lance Dial**, a partner at **K&L Gates**.

Ever since the 1994 establishment of the exclusive benefit rule, which requires Erisa plans to operate for the exclusive interest of plan participants, successive administrations have gone back and forth on the rule's scope and jurisdiction, leading to the avoidance of ESG-related investments by plan sponsors who see the area as "unsettled" and a "regulatory risk," he said.

Depending on the outcome of the 2024 presidential election, a new administration could reverse the DOL's 2022 amendments to instead mirror the language of the 2020 version of the rule, which was finalized under former President Donald Trump, several attorneys noted.

"The district court analysis and, frankly, the DOL rule are both very well-reasoned," Dial said. "But when you think of the context of where we're at with [the exclusive benefit rule], a lot of times this is politics and not law."

Some industry attorneys suggested that the district court's September ruling in favor of the DOL, which was handed down by U.S. District Judge **Matthew Kacsmaryk**, a Trump appointee, may be hard for the state attorneys general to overcome in their ongoing appeal.

The appellants reiterated their allegations in a reply brief filed on Apr. 11.

"Ties or no ties, what a fiduciary cannot do under ERISA is make decisions based on politics, ESG, or any other collateral considerations," the brief stated. "After all, the wisdom of prophylactic rules is that opening the door even a little to improper considerations risks too much."

Although the district court's September ruling in favor of the DOL indicated to some that a plaintiff victory was unlikely at the appellate court level, the 5th Circuit in 2018 vacated the DOL's fiduciary rule, reversing a lower court's ruling that initially upheld that rule. The agency in late October introduced a revamped version of the fiduciary rule and is poised to finalize it within the coming weeks.