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Gov't Retirement Plans Should Approach ESG Cautiously

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Although investment funds employing environmental, social and governance, or ESG, strategies are gaining in popularity, the U.S. Department of Labor has long been hostile to them.

Since 1994, the DOL has emphasized that fiduciaries of Employee Retirement Income Security Act plans are prohibited from making investment decisions on the basis of any factor other than the economic interest of their plan. As a result, fiduciaries are not permitted to sacrifice investment returns or take on additional risk as a means of using plan investments to promote societal policy goals.

In June 2020, the department doubled down on its enmity to ESG strategies by proposing a rule expressly requiring ERISA plan fiduciaries to make investment decisions solely for economic reasons and prohibiting them from sacrificing returns to promote nonpecuniary social goals.

And recently, in furtherance of its views in this regard, the department has begun investigating sponsors of ERISA plans that use funds employing ESG strategies as options in their retirement plans.

The department's hostility to ESG strategies has encountered significant opposition by asset managers, but in the short term, the department's investigations are likely to result in significantly reduced reliance on ESG strategies by private sector plans to avoid being targeted for investigation.

Plans sponsored by local and state governments are exempt from ERISA's fiduciary requirements and DOL scrutiny, so it is an open question whether the fiduciaries of such plans can implement ESG investment strategies. This article suggests that while the sponsor of a government plan cannot compel the fiduciaries of its plan to offer or make ESG investments, the fiduciaries can elect to do so if certain conditions are satisfied.

Typical Scenario: Fossil Fuel Divestment

Suppose you are the trustee of a defined benefit pension plan sponsored by a California city and, in the spirit of the times, the mayor orders the plan to divest from fossil fuels and reinvest the proceeds in renewable energy projects. Must you, as a trustee of the city's plan, implement the mayor's orders even if you believe they will result in plan losses? Thankfully, there is a clear path to resolving this dilemma.

The Duty of Loyalty

First, you consult your lawyers and they remind you that as a fiduciary of a pension plan, you have two core duties: the duty of loyalty and the duty of care. The duty of loyalty determines to whom you

are responsible in carrying out your obligations. And the law is quite clear that a plan fiduciary owes his/her loyalty to just one group: the members and the beneficiaries of the plan, and no one else.

That's what the common — or judge-made — law says, that's what the Internal Revenue Code provides and that's what the California Constitution requires.

Accordingly, you do not owe any duties to the city, the unions, the taxpayers or anyone other than the plan's members and beneficiaries, and this is so even if you are a city official. Since you do not owe a fiduciary duty to the city, you are not obligated to invest as the mayor commands.

The Duty of Care

However, while a plan's trustees are not obligated to invest as their sponsor may request, they can certainly consider the sponsor's suggestions. And to determine whether the sponsor's request to divest from fossil fuels is worthwhile, your lawyers remind you of your second core duty, which is your duty of care.

A fiduciary's duty of care is generally recognized as the obligation to exercise the care, skill and diligence that would be employed by a prudent person similarly situated. The California Constitution also stresses that fiduciaries must diversify plan investments to minimize risk of loss and maximize returns, and it is this emphasis on maximizing returns and minimizing losses that resonates throughout the law.

Thus, it is no surprise that the DOL stresses that plan fiduciaries are to refrain from making investment decisions on the basis of any factor other than the economic interests of their plan and cannot sacrifice returns or take on additional risk as a means of using plan investments to promote collateral social goals.

Is Divestment Profitable?

So, in light of your duty of care, should you divest from fossil fuels and reinvest the proceeds in renewable energy projects? The answer lies in whether such action would increase the plan's returns and decrease its investment risk. If the answer is yes, then divestment would comport with your duty of care.

If divestment would materially impair the plan's interests economically, then divestment would be precluded as contrary to your duty of care. If divestment would have a negligible effect on the plan's fiscal health, then we think divestment can be considered.

To arrive at a reasoned determination whether divestment of fossil fuels makes economic sense, we would expect a reasonable fiduciary to first crunch the numbers to determine whether divestment would be profitable. Then, presuming divestment was economically beneficial, it would be worthwhile to investigate the experience of other pension systems electing to divest from fossil fuels.

For example, the California Public Employees' Retirement System and California State Teachers Employees' Retirement System have both committed to divest from coal company investments and have approached divestment from the perspective of managing risk. Both systems prefer constructive engagement to divestment as a means of affecting corporate conduct and have adopted formal divestment policies.

Government plans considering a divestment strategy would benefit from examining the CalPERS and CalSTRS policies and experience.

The bottom line is this: A government plan sponsor cannot require a plan fiduciary to implement an ESG strategy. Nevertheless, if implementation of ESG strategies would increase the plan's returns and decrease its investment risk, or at the very least, have a neutral impact on risk and return, such strategies can be considered by the plan's fiduciaries.

Many communities are pressing asset managers to employ ESG strategies, especially those designed to address climate change. Given these pressures, plan trustees will be sorely tempted to invest with managers employing ESG strategies, but they must ensure that such deployments make fiscal sense

or at the very least, don't impair their plan's fiscal health. To do otherwise would be to invite criticism that the trustees are breaching their duty of care to their members.

To protect themselves from criticism that ESG investments are not productive, fiduciaries considering such investments should require potential managers to demonstrate the profitability of their strategies over their non-ESG competition. Trustees who demand such demonstrations upfront will be glad they did in the event a manager's expected returns do not materialize and critics with 20/20 hindsight then pounce.

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