Employee Benefits Newsletter
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Services

Employee Benefits and Executive Compensation

Fiduciary Duties and Governance

Qualified Retirement Plans

Taft-Hartley Plans

Health and Welfare Plans

Government Plans

Higher Education

Employee Stock Ownership Programs (ESOPs)

Executive Compensation and Nonqualified Plans

ERISA and Benefits Litigation

College Savings and ABLE Plans

Mandatory Paid and Unpaid Leave

Audits and Investigations

Where Are We Now: ESG Investing

In November 2022 the Department of Labor ("DOL") released a Final Rule permitting retirement plan fiduciaries to consider environmental, social, and governance ("ESG") factors when selecting plan investments. Under the Final Rule, ESG factors may be considered in an investment's risk-return analysis. The Final Rule became effective February 1, 2023, with certain proxy voting provisions becoming effective December 1, 2023.

The Final Rule reverses the prior 2020 rule that directed fiduciaries to select investments solely on financial factors. The 2020 rules required competing investments be economically indistinguishable before turning to non-financial factors and imposed documentation requirements on the use of non-financial factors.

As this article discusses, ESG has faced scrutiny over the past year from state attorneys general, state and federal legislators, government officials, and private parties.

State ESG Efforts

In *Utah v. Su et al.*, attorneys general from 26 states filed a lawsuit against the DOL in the U.S. District Court in Amarillo, Texas, alleging that the DOL overstepped its authority when it issued the Final Rule because it undermines a fiduciary's prudence obligations. They argued that when considering ESG factors fiduciaries necessarily stray from ERISA's mandate to act solely in the best interests of participants and beneficiaries because they effectively substitute their own (or a third party's) ESG policy preferences when making investment decisions. In response, the DOL argued that the Final Rule adequately explains its stated rationale of diminishing the "chilling effect" of the 2020 rule. On September 21, 2023 the judge sided with the DOL, stating the "2022 rule provides that where a fiduciary reasonably determines that an investment strategy will maximize risk-adjusted returns, a fiduciary may pursue the strategy, whether pro-ESG, anti-ESG, or entirely unrelated to ESG." On October 26, 2023, plaintiffs filed a notice of intent to appeal the judge's decision, so now the matter will be heard by the U.S. Court of Appeals for the Fifth Circuit.

Rather than litigate the ESG rule, Missouri and other conservative-led states passed legislation aimed at combating the Final Rule. The Missouri regulations, effective July 30, 2023, require additional recordkeeping for advisors and brokers recommending or selecting investments with a "non-financial objective" and require advisers and brokers to obtain client signatures on

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a document before giving advice that includes non-financial objectives. These regulations were challenged by the Securities Industry and Financial Markets Association in an August 10, 2023 lawsuit, which argues that federal law already requires an advisor to act in their client's best interest. The lawsuit argues that this regulation would restrict an advisor's ability to act in their client's best interest because it does not precisely define what "non-financial objective" means.

Participant-Led Litigation

In February 2023, participants in different employers' retirement plans filed a lawsuit in the U.S. District Court in Milwaukee, Wisconsin (*Braun v. Walsh*) against the DOL, alleging the Final Rule upends ERISA's standards of prudence and loyalty. Further, because the Final Rule removes the 2020 rule's documentation requirements, participants have no way to hold accountable plan fiduciaries who choose to consider ESG factors. The plaintiffs argue that ESG investing historically results in lower returns and higher costs to participants, which violates the fiduciary duty of prudence.

In June 2023, Bryan Spence, a participant in the American Airlines, Inc. 401(k) Plan for Pilots, filed a lawsuit (*Spence v. American Airlines, Inc.*) against American Airlines and the American Airlines Employee Benefits Committee alleging that American Airlines breached its fiduciary duties by investing in investment funds that pursue "political agendas" through ESG investing. Spence argues that the plan's fiduciaries violated their duty of loyalty because ERISA mandates that the "exclusive purpose of plan investments is to maximize financial benefits for participants." The complaint reiterates that when fiduciaries select the plan's menu, they must engage in a "reasoned decision making process for investigating the merits of each investment option and ensure that each one remains in the best interest of plan participants." Spence argues that including ESG investment options in the plan breaches the sole interest rule, because it means considering the interests of individuals other than the plan's participants and beneficiaries.

Finally, in *Wong v. New York City Employees' Retirement System*, participants in the New York City Qualified Pension Plans sued their respective pension administrators for breaches of fiduciary duty relating to the plans' decision to divest from fossil fuel investments. The complaint argues that the plans' 2021 decision to divest from holdings in fossil fuel companies is an "utter abandonment of fiduciary responsibilities" that runs afoul of common law protections and New York's regulatory standards for public retirement systems. Plaintiffs allege these investments delivered exceptional returns (i.e., 58%) during the 2022 divestment period, and this divestment amounted to abuse of discretion over plan assets in a "misguided and ineffectual" effort to address climate change. Plaintiffs seek an injunction that would require the plans to rescind their divestment policy and make decisions going forward "exclusively on relevant risk-return factors" but do not seek monetary damages.

Activist Efforts

During 2022, over 300 ESG related shareholder proposals were put to a vote, up 20% from 2021. These proposals included requiring audits of a company's retirement plan investment menu to determine the menu's impact on climate change and complete divestment from certain funds that activists deem as fueling climate change. In December 2022 Microsoft

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rejected a shareholder proposal targeting the Microsoft 401(k) Plan's default investment—the BlackRock LifePath funds. The proposal provided that Microsoft should mitigate the climate change-related impact of the plan's investment menu. As You Sow, a non-profit focused on shareholder activism behind many of these ESG related shareholder proposals, argues that climate change poses an "enormous risk" to the economy; therefore, by not taking the climate impact of investments into account, a fiduciary is not acting in the best interest of its participants and beneficiaries.

Until the fate of ESG litigation and the various cases has been resolved, fiduciaries must be aware of the potential risks when choosing to offer investments that have been selected based on ESG factors. If you have questions surrounding the developments in ESG investing and how it affects your role as a fiduciary, contact a member of Kutak Rock's Employee Benefits and Executive Compensation Practice Group.

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