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Federal Court Rules ESG-Guided Investing of 401(k) Plan Is a Breach of Fiduciary Duty

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Following a bench trial, Judge O'Connor (N.D. Tex.) held that “that Defendants breached their fiduciary duty by failing to loyally act solely in the retirement plan's best financial interests by allowing their corporate interests, as well as BlackRock's ESG interests, to influence management of the plan.” In other words, investing a 401(k) retirement plan to reflect ESG interests--rather than strictly financial ones--constitutes a breach of the fiduciary duty of loyalty. (Notably, despite this holding, the court nonetheless ruled that the fiduciary duty of prudence had not been violated, because ESG-influenced investing was “act[ing] according to prevailing industry practices.”) In so holding, the Court emphasized that “[w]hile it is permissible to consider ESG risks when done through a strictly financial lens . . . ESG cannot stand on its own. . . . [as] ERISA does not permit a fiduciary to pursue a fiduciary to pursue a non-pecuniary interest no matter how noble it might view the aim.”

This decision--the first to consider ESG-focused investing of a 401(k) plan following a trial on the merits--will undoubtedly be influential, as it supports the position advocated by a number of critics of ESG that such ESG-influenced investment activity is *per se* a breach of fiduciary duty. Additionally, as this decision was issued by a federal district court in Texas, it is likely that it will be upheld on appeal, as the Fifth Circuit Court of Appeals--which oversees this particular district court--is the most conservative in the United States.

Still, this ruling does also offer a partial roadmap for ESG-focused investing to survive such challenges--as if ESG-focused investing can be justified based upon financial metrics, than it will pass legal muster.

Based upon the results in this case--although damages are yet to be determined--it is likely that additional lawsuits will be filed on behalf of 401(k) participants against investment managers who made use of ESG factors when determining investments.

> American Airlines Inc. violated federal law by filling its 401(k) plan with funds from investment companies that pursue environmental, social, and corporate governance goals, a Texas federal judge ruled Friday in the biggest victory yet for opponents of the strategy. The airline breached its fiduciary duty of loyalty—but not its fiduciary duty of prudence—in allowing its $26

billion retirement plan to be influenced by corporate goals unrelated to workers' best financial interests, Judge Reed O'Connor of the US District Court for the Northern District of Texas said after a four-day, non-jury trial. The 2023 lawsuit, which says the airline wrongly offered 401(k) funds managed by companies that pursue ESG policy goals through proxy voting and shareholder activism, is the latest battle in the broader debate over socially conscious investing.

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