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Pecuniary vs. Nonpecuniary Factors: Understanding the Potential Scope of Anti-ESG Restrictions in U.S. State Laws

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Executive Summary and Overview

- State anti-ESG lawmakers have enacted legislation aimed at restricting investors from considering ESG factors in their investment strategies and decisions by requiring state financial institutions to account for only "pecuniary" factors in evaluating an investment opportunity and not "nonpecuniary" factors.

- States have adopted different ways of delineating pecuniary and nonpecuniary factors:

  - Pecuniary factors defined sufficiently broadly to *include* ESG considerations (e.g., Alaska, North Carolina, Montana) provided there is an impact on financial risk and return (the assessment of the impact required varies between states);

  - Pecuniary factors defined to expressly *exclude* ESG considerations (e.g., Florida)—this "bright line" rule, while untested, would seem to prohibit ESG considerations even if they have an impact on financial risk and return; and

  - Attributing a presumption that there has been consideration of nonpecuniary factors through a fiduciary's membership of ESG-related coalitions, agreements etc. (e.g., Kansas, Kentucky, Indiana).

- The 2022 Department of Labor ("DOL") ERISA Rule currently holds that, if a fiduciary determines that an investment strategy will maximize risk-adjusted returns, a fiduciary may pursue the strategy whether pro, anti, or ESG-agnostic.

- The proposed ESG Act, if enacted, would extend the 2020 DOL ERISA Rule as formulated under the Trump administration to brokers, dealers, and investment advisers, such that these service providers can consider only pecuniary factors that they prudently determine will have a material effect on the risk or return of an investment.

- In light of the legislative activity in this area, it is increasingly important for fiduciaries to analyze and demonstrate the effect of ESG factors on pecuniary outcomes.

I. Introduction

In recent years, environmental, social, and governance ("ESG") considerations have assumed a distinctly pivotal role in shaping the decision-making processes of sponsors, investors, and financial institutions. Proponents of ESG point to the interconnectedness and correlation between companies' financial performance and its environmental sustainability and social impact. Conversely, the Anti-ESG camp views ESG as social engineering or pushing "progressive ideas in society and business."[1]

State Anti-ESG lawmakers have responded by introducing and enacting legislation aimed at restricting investors from considering ESG factors in their investment strategies and decisions, by requiring state financial institutions to account for only "pecuniary" factors in evaluating an investment opportunity and prohibiting or restricting the consideration of any "nonpecuniary" factors. States have adopted several general approaches to delineating pecuniary and nonpecuniary factors: (1) pecuniary factors defined to include certain ESG considerations; (2) pecuniary factors defined to exclude any ESG considerations; and (3) attribution of nonpecuniary characteristics to an investment decision based on a fiduciary's statements or membership in ESG-related coalitions, initiatives, agreements, or commitments. Notably, the final category raises potential constitutional concerns under the First Amendment, which we explore briefly in this article.

From an investor's perspective, this pecuniary versus nonpecuniary distinction tends to create more questions than answers. While there is a dearth of case law precedent clarifying what may constitute pecuniary or nonpecuniary factors in the context of an investment decision, here we review various state-level anti-ESG laws, federal-level definitions under ERISA, and legal challenges to some of those approaches, to provide considerations for investors in this dynamic and fraught area.

A. State Approaches to Pecuniary Versus Nonpecuniary

1. Pecuniary Factors Defined to Include ESG Considerations

The least restrictive definitions of pecuniary and nonpecuniary factors are found in the anti-ESG laws adopted in Arkansas (HB 1253), Montana (HB 228), and North Carolina (HB 750). These three states define pecuniary factors relatively broadly, allowing for circumstances under which ESG considerations may be deemed pecuniary factors.

For example, Arkansas defines "pecuniary factor" as "a factor that has a material effect on the financial risk or financial return, or both, of an investment[.]"[2] In Arkansas, a "pecuniary factor" is distinguished from any "nonpecuniary" factor, defined as "any action taken or factor considered by a fiduciary with any purpose to further environmental, social, political, or ideological goals."[3] Nevertheless, "an environmental, social, corporate governance, or other similarly oriented consideration" can be a pecuniary factor if it "presents an economic risk or opportunity" that is not primarily related to events "involving a high degree of uncertainty regarding what may occur in the long-term future" or events that are "systemic, general, or not investment-specific in nature."[4] Hence, an ESG factor may be considered "pecuniary" if it stands to cause an apparent *economic* impact on an investment decision.[5]

Comparably, the law in North Carolina specifies that the weight given to pecuniary ESG factors "shall solely reflect a prudent assessment of their impact on risk and return."[6] Reference to terms like "material effect" and "prudent assessment" places the burden on investors to demonstrate the financial "hook" of their ESG considerations, with courts as the final arbiters as to whether investors have met those standards.[7]

Meanwhile, Montana's anti-ESG law, which contains similar definitions as those prescribed in the laws adopted by Arkansas and North Carolina, is less subtle in that it imposes a relatively more concrete evaluation standard. It adds, "[A]ny pecuniary consideration of environmental, social, governance … must necessarily include evaluating whether greater returns can be achieved through investments that rank poorly on these factors."[8] Montana law thus appears to impose a higher burden by requiring investors to assess whether greater returns can nonetheless be achieved through investments that underperform in ESG categories, even if other investments tend to rank higher on an ESG scale.

These laws have yet to be litigated. It is nonetheless clear that, while these laws are constructed as inclusive of ESG considerations, they impose at least some affirmative requirements on investors seeking to include ESG considerations in their investment evaluations.

2. Pecuniary Factors Defined to Exclude ESG Considerations

On the other hand, Florida (HB 3) prohibits ESG considerations as nonpecuniary in nature, without caveat. The law states that a "pecuniary factor" means a factor "expected to have a material effect on the risk or returns of an investment[,]" and does not include "the consideration of the furtherance of any social, political, or ideological interests."[9] Unlike the laws adopted in Arkansas, Montana, and North Carolina, Florida does not separately acknowledge circumstances in which ESG considerations may nonetheless have an economic effect on an investment. The bright-line rule in Florida therefore prohibits investors from incorporating any ESG considerations into their investment decisions. As a result, Florida courts will likely expect any investor under scrutiny for violating this law to be able to present an entirely "pecuniary," non-ESG line of reasoning to avoid liability.

3. Presumption of Nonpecuniary Factors

A number of states impose anti-ESG laws even more restrictive than Florida's bright-line approach. Anti-ESG laws adopted in Kentucky (HB 236), Kansas (HB 2100), and Indiana (HB 1008) not only identify ESG factors as nonpecuniary but also allow their courts to infer that a fiduciary has considered or acted on such nonpecuniary interest based on extrinsic evidence beyond the investment decision itself. This can come in the form of evaluations of the investment firm's fiduciary's statements, communications with portfolio companies, and even membership in coalitions, initiatives, agreements, or commitments.

Kentucky's anti-ESG law, for instance, defines pecuniary factor as "a consideration having a direct and material connection to the financial risk or financial return of an investment."[10] The law states that a nonpecuniary interest includes "an environmental, social, political, or ideological *interest*."[11] Notably, evidence that a fiduciary has considered a nonpecuniary "interest" encompasses, among other things, the "coalitions, initiatives, agreements, or commitments to which the fiduciary is a participant, affiliate, or signatory."

Kansas's and Indiana's anti-ESG laws employ the same "interest" language. In Kansas, a pecuniary or "financial" factor does not include "any action taken or factor considered by a fiduciary with any purpose whatsoever to further social, political, or ideological *interests*."[12] Indiana also specifies that the term "financial" does not include "an action taken or a factor considered by a fiduciary with the nonfinancial purpose to further social, political, or ideological *interests*."[13] However, Kansas's and Indiana's anti-ESG laws arguably elevate restrictions on ESG interests beyond that of Kentucky. The concern is that, since both states can use "any action taken or factor considered" as evidence that fiduciary has pursued social, political, or ideological interests, any commitment or statement made in support of an environmental and social concern or goal, such as with respect to greenhouse gas emissions or board composition, can be used against them without limitation to infer a violation of this legislation.[14] This expansive language likely grants courts sweeping powers under state law to penalize investors for aligning themselves with ESG initiatives, regardless of whether ESG factors are factually present in any one investment decision.

4. <u>First Amendment Challenges to State Anti-ESG Measures</u>

While the varying definitions of pecuniary and nonpecuniary factors have not been directly challenged in court, certain lawsuits have been filed in recent years against other similar anti-ESG measures, signaling a backlash by investors against these restrictions.

For instance, in August 2023, a lawsuit was brought in the Western District of Missouri challenging Missouri's anti-ESG rules requiring financial services professionals to disclose any use of ESG objectives in their investment decisions. In particular, the rules require any firm that incorporates a social or non-financial objective into investment decisions to issue their clients a "state-authored" statement that their "investment advice 'will result' in advice that is not 'solely focused on maximizing a financial return.'"[15] The plaintiffs argued, among other things, that the Missouri rules constitute compelled speech in violation of the First Amendment. Namely, the rules force affected financial professionals to characterize their investment strategies as "not solely focused on maximizing a financial return[,] … even in situations where the financial professional does not believe that statement to be accurate."[16] The plaintiffs further noted that, when the rules were initially proposed as a bill, the bill did not pass at least in part due to First Amendment concerns.

Although voluntarily dismissed, a similar First Amendment challenge was filed in Oklahoma in December 2023, alleging that the state's anti-boycott law requiring written certifications from financial institutions that they do not boycott energy companies "compel[led] speech, is viewpoint discriminatory, and content discriminatory."[17]

In light of these constitutional challenges, it remains to be seen whether some of the more restrictive approaches to the pecuniary and nonpecuniary distinction in state Anti-ESG laws would survive any future lawsuits employing similar First Amendment arguments about investors' rights to free speech and association.

B. Federal Approaches to Pecuniary Versus Nonpecuniary

Beyond the realm of state Anti-ESG laws, the distinction between pecuniary and nonpecuniary factors has been relevant in the context of the duties of plan fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA"), under their duty of prudence, which requires plan fiduciaries to diversify plan investments to reduce the risk of substantial losses, unless it is demonstrably prudent not to do so.[18] The statute further requires plan fiduciaries to act solely in the interests of plan participants and for the benefit of the plan beneficiaries.[19]

The term "pecuniary" became a focus when the Trump administration amended the US Department of Labor ("DOL") regulations relating to ERISA in 2020 (the "2020 DOL Rule"). The 2020 DOL Rule explicitly required plan fiduciaries to consider exclusively "pecuniary" factors in making investment decisions and exercising shareholder rights.[20] Under the 2020 DOL Rule, a "pecuniary factor means a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy[.]"[21] The 2020 DOL Rule also included a so-called "tie breaker rule," which allowed plan fiduciaries to consider "a non-pecuniary factor" only when it could be demonstrated that, "after an evaluation, alternative investments appear economically indistinguishable."[22]

However, on March 10, 2021, only a few months after the 2020 DOL Rule took effect, the Biden administration launched a reexamination of the rule in one of its first Executive Orders.[23] On December 1, 2022, the DOL released a new rule (the "2022 DOL Rule"), which removed the "pecuniary" and "nonpecuniary" nomenclature of the 2020 DOL Rule. It explained that there was significant confusion among stakeholders concerning the "appropriate integration of climate change and other ESG factors in investment decisions."[24] As a result, the term "pecuniary factors" was replaced with the instruction that plan fiduciaries' investment decisions "must be based on factors that the fiduciary reasonably determines are relevant to risk and return analysis."[25] Moreover, the 2022 DOL Rule modified the language of the tie breaker rule to replace the term "nonpecuniary" with "collateral benefits": If a fiduciary "prudently concludes that competing investments … equally serve the financial interests of the plan," the fiduciary is "not prohibited from selecting the investment … based on *collateral benefits* other than investment returns."[26]

Since the 2022 DOL Rule came into effect on January 30, 2023, it has faced only one direct challenge in *Utah v. Walsh*, a Texas federal court case where the plaintiffs sued the DOL for forcing them "to expend additional time and resources monitoring … to assure the advisors are focusing only on pecuniary considerations and not collateral ESG factors … and that oil and gas companies will likely be further harmed by decreased interest from investment capital."[27] In particular, the plaintiffs argued that the plain text of ERISA forecloses consideration of non-pecuniary factors, and the 2022 DOL Rule's replacement of "pecuniary" language makes the rule arbitrary, capricious, and manifestly contrary to the statute.[28]

The *Walsh* court rejected both arguments, noting that "an ESG factor could be worth consideration" as a pecuniary factor, "even under prior rules if it is expected to have material effect on the risk and/or return of an investment."[29] The court acknowledged that the 2022 DOL Rule still requires that ESG factors must reflect "a reasonable assessment of its impact on risk-return," and it concluded that the 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."[30]

This back-and-forth regarding the use of the pecuniary versus nonpecuniary distinction in the ERISA context is indicative of the larger ongoing debate regarding the general utility of these terms in assessing the legality of fiduciaries' investment decisions. Should the courts apply the definitions for "pecuniary" and "non-pecuniary" similarly with respect to anti-ESG laws, it is conceivable that these definitions will likely evolve in tandem with shifts in the political landscape. Indeed, in March 2023, President Biden issued his first veto on a congressional resolution seeking to override the 2022 DOL Rule. The resolution was pushed heavily by then-House Speaker Kevin McCarthy, who had made clear that anti-ESG would remain a policy priority.[31]

Outside of ERISA, there is pending federal legislation that aims to expand the pecuniary versus nonpecuniary distinction beyond the fiduciaries of employee pension plans. In June 2023, Republican members of U.S. Congress introduced the Ensuring Sound Guidance Act, also known as the ESG Act.[32] This bill first proposes to amend the Investment Advisers Act of 1940 ("IAA") to extend the pecuniary and nonpecuniary distinction to brokers, dealers, and investment advisers registered under the IAA, providing that such service providers can only consider "pecuniary factors" when giving advice or making decisions in the best interests of their clients, "unless the customer provides informed consent, in writing, that such non-pecuniary factors be so considered."[33] The bill, in turn, additionally proposes to reinstate the 2020 DOL Rule definition for "pecuniary factor" into ERISA and incorporate the term by reference into the IAA. While the ESG Act is the only bill of its kind pending in the House, it is clear from the bill's construction that Republican lawmakers are looking to mirror the framework of definitions established in the Trump administration's 2020 DOL Rule and apply it to fiduciaries in other contexts.

II. Conclusion and Key Takeaways

The last couple of years have seen momentous evolution in how business leaders and investors view ESG in the context of their corporate strategies and investment decisions. Parallel with this development, however, has been an upsurge in state anti-ESG bills and other related measures across the United States, directed at counteracting the newfound prominence of ESG-forward investing.[34]

These new anti-ESG laws employ the terms "pecuniary" and "non-pecuniary" factors to distinguish the considerations that investors are and are not legally allowed to factor into their investment decisions. Nevertheless, these terms are not well-defined, and courts have yet to make determinations on the matter. Moreover, this terminology is deeply tied to the shifting political landscape. Thus, affected investors should assess how the current and upcoming administrations could affect the ways in which lawmakers and the courts perceive the role of ESG in the capital market system.

With respect to the ESG landscape, it is important for investors and investment advisors to understand the legal, regulatory, and political developments taking place in the jurisdictions where they operate and attract investors. In light of the ongoing proliferation of anti-ESG laws, investors can safeguard themselves by aligning all investment decisions with a strictly financial—or "pecuniary"—purpose. Where does this leave ESG considerations? To this end, it is crucial that investors are attentive to the growing importance of identifying and assessing—in partnership with advisers and subject matter experts—the pecuniary impact of ESG factors in their investment decisions.

Paul Hastings' ESG Team advises sponsors, investors, financial institutions, and companies on how the ever-shifting ESG landscape may affect their business decisions, the impact of ESG factors on pecuniary outcomes, whether ESG factor(s) may have a material effect on financial risk or financial return, or both, of an investment, as well as strategies to address that potential impact.

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[1] Andrew Winston, "ESG Is Under Attack. How Should Your Company Respond?", Harvard Business Review (December 22, 2023).

[2] Ark. Code. Ann. §§ 24-2-801–06 (2023).

[3] *Id*.

[4] *Id*.

[5] In the realm of damages, state laws use the term "pecuniary"to generally refer to "tangible, economic losses,"while "nonpecuniary"refers to other types of harms, such as emotional losses and reputational damage.Thus, like in the investment context, the distinction between pecuniary and nonpecuniary in non-investment contexts has been drawn around whether something is "of or pertaining to money."

[6] N.C. Gen. Stat. Ann. §§ 143-162.6–7 (2023).

[7] The Supreme Court has weighed in on the general standard for assessing "materiality"in the corporate context.Something is *material* when there is a "significant likelihood" that it would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus*., *Inc*. *v*. *Northway*, *Inc*., 426 U.S. 438, 449 (1976); *see also id*. at 450 ("The determination [on materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him."). Meanwhile, the standard for "prudence" is relatively well established in common law. Under the "prudent-person" rule, courts have historically held that fiduciaries must invest in an objectively reasonable manner, "considering the probable income, as well as the probable safety of the capital to be invested." *Harvard Coll*. *v*. *Amory*, 26 Mass. 446 (1830).

[8] Mont. Code. Ann. §§ 17-6-231–34 (2023) (emphasis added).

[9] Fla. Stat. Ann. §§ 1010–13 (2023).

[10] Ky. Rev. Stat. Ann. §21.450, §§ 61.645–50 (2023).

[11] *Id*. (emphasis added).

[12] Kan. Stat. Ann. §§ 75-42a01–06 (2023) (emphasis added).

[13] Ind. Code. Ann. § 5-10.2 (2023) (emphasis added).

[14] *Id*.; Ind. Code. Ann. § 5-10.2 (2023).

[15] Complaint at 6, *Securities Industry and Financial Markets Ass'n v. Ashcroft* (W.D. Mo. 2023) (No. 2:23-cv-04154-SRB) (citing 15 CSR § 30-51.170(3)(D)).

[16] Complaint at 38, *Securities Industry and Financial Markets Ass'n v. Ashcroft* (W.D. Mo. 2023) (No. 2:23-cv-04154-SRB).

[17] Complaint at 4, *Keenan v. State of Oklahoma* (W.D. Okla. 2023) (No. 5:23-cv-01121-D).

[18] 29 U.S.C. § 1001 et seq. (2018).

[19] *Id*.

[20] 29 CFR § 2550.404a–1(c)(1) (2020).

[21] 85 Fed. Reg. 72846 (2020).

[22] 29 CFR § 2550.404a–1(c)(2) (2020).

[23] *See* 86 Fed. Reg. 7037 (2021).

[24] 87 Fed. Reg. 73822 (2022).

[25] *Id.*; 29 CFR § 2550.404a–1(b)(4) (2022).

[26] 29 CFR § 2550.404a–1(c)(2) (2022) (emphasis added).

[27] *Utah v. Walsh*, No. 2:23-CV-016-Z, 2023 WL 6205926, at *2 (N.D. Tex. Sept. 21, 2023).

[28] *Id*. at *3.

[29] *Id*. at *5.

[30] *Id*.

[31] John McGowan, *Despite McCarthy Ousting, Congressional Conservative's Anti-ESG Agenda Is Safe*, Forbes (October 4, 2023), https://www.forbes.com/sites/jonmcgowan/2023/10/04/despite-mccarthy-ousting-congressional-conservatives-anti-esg-agenda-is-safe.

[32] H.R. 4237, 118th Congress (2023–24).

[33] *Id*.

[34] Most recently, in March 2024, Mississippi's Secretary of State issued a cease-and-desist order alleging that an asset manager has made false and misleading statements about the funds it marketed as "non-ESG" when in fact those funds advance the environmental goal of reducing carbon emissions to net zero. *See* Sarah Jarvis, *BlackRock's Non-ESG Funds Have Green Agenda, Miss. Says*, Law360 (March 27, 2024), https://www.law360.com/compliance/articles/1818285.