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THE LAW EVERY TRUSTEE MUST KNOW

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I. FIDUCIARY DUTY - A DEFINITION

A. Fiduciary Defined

1. A person is a fiduciary with respect to an employee benefit plan to the extent he/she exercises discretionary authority with respect to plan and assets.

2. Exercise of discretion is the key.

3. Can include more than just the trustees.

4. Extends to investment management and benefit administration.

B. Judicial Standards

1. **Meinhard v. Salmon, 164 NE 545 (Ct.App. 1928)**

   Court determines that common standard of the marketplace is unacceptable to fiduciaries. General trust standard was expanded for pension trustees to include a definition of "undivided loyalty" to be applied with "uncompromising rigidity."

2. **NLRB v. Amax Coal Co., 453 U.S. 322 (1981)**

   U.S. Supreme Court holds that plan trustees have an "unwavering duty of complete loyalty" to members and beneficiaries. Trustees cannot serve any master other than the fund. The pressures of undivided loyalty are inconsistent with the give and take of collective bargaining.

II. INCOMPATIBILITY OF OFFICE

A. Common Law Standards

Incompatibility exists where duties of two officers are such that when placed in one person they might disserve the public interest or if the respective offices might or will conflict even on rare occasions.

B. Legislative Standards

1. Dual office holding prohibitions.

2. State ethics/conflict of interest laws - Examples

III. ECONOMICALLY TARGETED INVESTMENTS

A. Currently billions of dollars of public and private pension money has been placed into economically targeted investments (ETI's) which are designed to create jobs, boost local economies or create affordable housing.

B. ETI's (also called Social Investing) criticized for failure to provide a solid economic return to the pension fund.

C. Future benefit enhancements may be subjected to political hostage taking in return for ETI's for cash strapped state and local governments.

D. Modern Portfolio Theory - The Difference Between the Prudent Person, the Prudent Investor, and the Prudent Expert.

1. In the literature discussing the duties of pension trustees in the area of investment responsibility, terms like "prudent person," prudent investor," and "prudent expert are used. While the terms are sometimes used interchangeably, their histories and meanings are distinct.

2. In *The New Prudent Investor Rule and Modern Portfolio Theory: A New Direction for Fiduciaries,* Alberts and Poon, 34 AMBJ 39 (1996), the history of fiduciary duty is explored at length from its biblical origins in Luke 16:1-8, 10 (the parable of the stewards) and St. Thomas Aquinas' *Treatise on Prudence and Justice* through the creation of the prudent expert rule under ERISA. American jurisprudence is said to begin with the decision in *Harvard College v. Amory*, 26 Mass. (9 Pick) 446 (1830) in which the Court held:

> "All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise

> a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

3. The adoption of the Employee Retirement Income Security Act of 1974, further extended this rule to a new, higher standard. The operative provisions of Section 404(a), codified as 29 U.S.C. 1104 (a)(1)(B), require a fiduciary to discharge his or her duties:

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

4. While ERISA Section 404 (a) has its foundations in the prudent person and prudent investor rules, legal scholars have concluded that the statute created a new "prudent expert rule."

5. While the ERISA standard is obviously based on the common law prudent investor rule, in many respects ERISA goes well beyond traditional requirements. For example, ERISA requires the care that a "man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This has been termed the "prudent expert" rule (as opposed to the prudent investor rule's "managing his own property" standard) and is perceived as imposing a higher standard. The legislative history indicates that the "enterprise of like character" language was intended to form a standard that would consider the attributes and diversity of employee benefit plans in federalizing the common law of trusts. Another major change wrought by ERISA is that it permits a fiduciary to emphasize the performance of the overall portfolio as compared with the performance of each individual investment. At common law, the fiduciary was required to defend the performance of each individual investment in the portfolio. Bobo, *Nontraditional Investments of Fiduciaries : Re-Examining the Prudent Investor Rule,* 33 Emory L J 1067, 1078 (1984). See

also, Hughes, *Hot Topics and Important Considerations for Retirement Plan Fiduciaries,* 57 - Jul Advoc 38 (June/July 2014), Note 7.

6. The key, according to the prudent expert standard is whether the trustees, at the time they engaged in an investment, employed appropriate methods to investigate the merits of the investment and its structure. *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.,* 173 F.3d 313 (5th Cir. 1999); *Donovan v. Mazzola,* 716 F.2d 1226 (9th Cir. 1983). Perhaps more importantly, the prudent expert standard (found in the Restatement (Third) of Trusts) greatly expands a trustee's ability to delegate to investment professionals. See, Langbein, *Reversing the Non-Delegation Rule of Trust - Investment Law,* 59 MOLR 105 (1994).

7. ERISA specifically exempts governmental plans like CalPERS. The reasoning at the time, and continuing today, is the management and funding of state and local government retirement plans is not a federal issue. It has been deemed a reserved power of the states under the 10th Amendment of the U.S. Constitution.

E. Responsible Investing - Doing Well by Doing Good

1. Environmental, Social and Governance (ESG) - Incorporates these issues into the investment decision making process as a means to enhance returns and reduce risk. Additionally, these approaches may involve active proxy voting, company engagement, and public policy work.

2. Mission Related Investing is a more focused type of ESG and is closely aligned with the mission of the organization. For example, one large church pension plan will not invest in stocks relating to gambling, firearms, alcohol, or private prisons. Church plans have even greater flexibility as they are unregulated by either state law or ERISA. The decision to invest or refrain from investing in certain industries is deemed a matter of faith and is exempt from judicial or legislative interference under the First Amendment of the U.S. Constitution and

comparable state constitutional provisions respecting freedom of religion.

3. Sustainable investing is generally focused on investments in companies addressing issues relating to conservation of natural resources, such as energy, air, and water.

4. Currently billions of dollars of public and private pension money have been placed into economically targeted investments (ETI's) which are designed to create jobs, boost local economies or create affordable housing.

5. The Labor Department began issuing responsible investing guidance for ERISA plans as early as 1998. Fund trustees were reminded that loyalty to the plan, diversification, and prudence were the primary investment determinants. Responsible investing was criticized for failure to provide a solid economic return to the pension fund. Later research has not shown a compelling economic difference. Focus has shifted from negative screening (limiting the opportunity set) to positive screening, yielding a more balanced approach of integrating the ESG principles into the over-all investment decision making process.

6 Social investing has been approved in the context of a political decision rather than a highest and best rate of return investment. *See, Board of Trustees v. City of Baltimore,* 562 A.2d 720 (Md. 1989). The Maryland high court held that requiring South African divestment did not impair the pension contract or subvert the purposes of the System when the plan sponsor adopting the requirement was willing to bear any economic consequences of the political decision.

F. Directed Investment Does Not Impair Constitutional Rights of Members

The West Virginia Legislature passed a bill directing the state pension board to invest $150 million of the state retirement fund assets in the jail authority for ongoing construction and renovation projects. The investment was for five years and had a guaranteed investment return equal to the fixed income portfolio of the system, but not less than 5%. The pension board refused to transfer the $150 million based on its

belief that it impaired the rights of members to their constitutionally-guaranteed pension benefit. The appeals court disagreed holding that as long as the state continued to pay the benefits of members that the contractual right to a pension was not impaired. The court held that the contract right was not as to the assets, but rather as to the "promised pay." The court held it was also not unconstitutional to direct the pension board's power to invest.

State Regional Jail and Correctional Facility Authority v. West Virginia Investment Management Board, 508 S.E.2d 130 (W.Va. 1998)

G. Divestiture Law Held Unconstitutional

Darfur Investment Restrictions Struck Down by Federal Court.

In an effort to deny support for the government of Sudan and its affiliated Jinjaweid militia in light of the atrocities and genocide in Darfur, the state adopted the Illinois Act to End Atrocities and Terrorism in the Sudan. The act attempted to impose various restrictions on the investment of public pension funds in Sudan-connected entities and on the deposit of state funds in financial institutions whose customers have certain links with Sudan. Among other things, the Act amended the Illinois Pension Code to prohibit the fiduciary of any pension fund established under the Code from investing in any entity unless the company managing the fund's assets certified that the fund managing company has not loaned to, invested in, or otherwise transferred any of the retirement system or pension fund's assets to a forbidden entity any time after the effective date of the Act. Several Illinois municipal pension funds and beneficiaries challenged the constitutionality of the statute in a suit brought under 42 USC 1983 against the state treasurer and attorney general. The plaintiffs argued that the Act is preempted by federal law governing relations with Sudan, interferes with the federal government's ability to conduct foreign affairs, violates the Constitution's Foreign Commerce Clause, and is preempted by the National Bank Act. The court recognized that the Illinois legislature acted with laudable motives. The Federal District Court for the Northern District of Illinois held that the Illinois act violated various federal constitutional provisions precluding the states from "taking

actions that interfere with the federal government's authority over foreign affairs and commerce with foreign countries." The District Court enjoined the state from enforcing the act.

National Foreign Trade Council v. Alexi Giannoulias, 2007 WL 627630 (N.D. Ill. Feb. 23, 2007)

H. Constructive Engagement

Many states, as an alternative to divestiture, have adopted laws requiring constructive engagement. See, for example, La. Rev. Stat. 11:314. This involves requiring managers to inquire of companies holding stock in areas of concern to directly engage those companies to seek change within the challenged area. California adopted a bill requiring divestment of thermal coal if constructive engagement fails to yield the required result. A similar fossil fuel measure passed in Washington, DC. A study by the State of Vermont concluded divestiture was not in the Fund's best interest.

IV. LEGAL CONSEQUENCES OF UNDERFUNDING\OVERFUNDING

A. **McDermott v. Regan,** 624 N.E. 2d 985 (N.Y. 1993)

The New York State Assembly passed a law changing the actuarial funding method for the state pension system. The law called for a switch from an aggregate cost method of funding to a projected unit credit method. The actuarial change eliminated $800 million in employer contributions. A "surplus" in the pension fund was created by the change in the funding methodology. The surplus was created by virtue of the fact that the former actuarial method funded the plan on a level basis and the new actuarial method did not. The surplus created by this change in methodology eliminated employer contributions for the next ten years. The plan trustee and the employees challenged the law on the basis that it impaired the contractual right to benefits. The New York Court of Appeals held that diverting accumulated pension funds through actuarial methodology changes for the purpose of meeting a financial crisis was an unconstitutional impairment of the security of the pension contract.

B. **<u>City of Lamar v. Lamar Police Department Pension Plan</u>,** 857 P.2d 457 (Co. App. 1993)

The City of Lamar withdrew from the state fire and police pension plan. Upon setting up its own plan, the City received a transfer of both the employee and employer contributions. The City kept the employer contributions to meet future needs of its own plan. The pension fund sued the City to get control of the former City contributions claiming that they belonged to the plan. The court held that plan monies are an asset of the trust and that the City, by virtue of transferring from a statewide plan to a city plan did not regain ownership rights in those monies. The City ordered to place transferred employer contributions immediately into pension trust.

C. **<u>PERB v. City of Portland</u>,** 773 P.2d 7 (Ore. App. 1989)

The City was deemed the employer of energy agency. The City failed to make any contribution or to withdraw employee contributions necessary to fund the energy agency pension plan. City held liable to make up both employee and employer contributions. City was not required to make up lost earnings. Court left unanswered the question of the City's right to be reimbursed for the employee contributions.

D. **<u>Getsie v. Borough of Braddock</u>,** 560 A.2d 875 (Pa. Cmwlth. 1989)

Employer failed to make the co-payment to the pension plan. The employer kept taking employee contributions and depositing them with the administrator. The administrator knew of employer's failure to contribute but failed to notify the employees. The employer held liable to make employees whole on their pensions and the administrator was held liable for a failure to notify.

E. **<u>West Virginia Education Association v. Consolidated Public Retirement Board</u>,** 460 S.E.2d 747 (W.V. 1995)

Teachers' association sued governor and retirement board claiming retirement system was actuarially unsound. Also challenged transfer of retirement funds to reimburse underfunded state group employees' insurance plan. Court held that inadequate funding is illegal and violates the employees' contractual rights to a pension. During

pendency of litigation, legislature passed the statute requiring funding and the court held further litigation on that issue moot. Court held that contributions, once made, are held in trust for the members. Court held that pension funds are not state or public funds and cannot be used for any purpose other than pension. Use of monies to reimburse insurance fund was held by the court to violate vested contractual rights of members and constituted illegal expropriation. The court also awarded attorney's fees for failure of public officials to do their clear public duty.

F. **Jones v. Board of Trustees,** 910 S.W.2d 710 (Ky. 1995)

Legislature amended statute regarding pension board's power to set contribution rates for the employer. Temporary suspension of the board's power to set rates was provided as result of a state budget crisis. Statute stated that pension is an "inviolable contract" not subject to reduction or impairment. Retirement board challenged change in its powers. Court held that contract is for a soundly funded pension and not the methodology by which that is achieved. Court held that the essence of the contract is the benefit of the promised level, not every aspect of the management of that process. Courts upheld legislation with the warning that if funding of benefits are impaired by the temporary suspension, then the suspension of the board's power to set the contribution rate is unconstitutional.

G. **Taylor v. State in Education Employees' Group Insurance Program,** 897 P.2d 275 (Ok. 1995)

State statute transfers funds from retirement system to insurance reserve. Constitutionality of transfer is challenged. Court denies challenge finding that benefits were not impaired and actuarial soundness was not impaired. Court noted that contemporaneous increase of tax revenue to retirement system to offset transfer to group insurance plan was a lawful "quid pro quo" and, therefore, no diminishment of benefits occurred.

H. **Dadisman v. Moore,** 384 S.E.2d 816 (W.V. 1989)

State of West Virginia intentionally underfunded retirement system by $80 million. Governor and legislature acted in complicity to improperly transfer pension appropriations back to the general fund. Trustees

failed to act to protect the fund and were accused by the Supreme Court of at worst acting in complicity and at best acting with gross negligence. Breach of fiduciary duty found even though no pension payments were missed. Unilateral reduction in employer share of pension contributions affects the integrity and security of the fund. The pension fund was found to be an independent trust and not taxpayers' money.

I. **State Ex. Rel. Dadisman v. Caperton,** 413 S.E.2d 684 (W.V. 1991)

In Dadisman v. Moore (1989) state supreme court ordered an actuarial review of the state retirement system to determine the extent of damage from intentional underfunding. The legislature resisted placing additional funds into the plan. In 1990, the legislature eliminated the two divisions of the state system for accounting purposes (the state employees' division and the local government division). Assets had always been pooled for investment purposes. Local government division members claim that their side had a surplus while the state division was underfunded. The court rejected claims of a separate right to trust funds claiming that the plan was actually unified. A merger of assets was held not to impair the pension contract. Assets held to belong to the system. The net effect was to permit surplus investment on behalf of local government employees to be used to offset intentional underfunding by state government.

J. **City of Miami v. Gates,** 393 So.2d 586 (Fla. 3rd DCA 1981)

City of Miami diverted pension fund assets to pay Worker's Compensation and general liability claims. Loss of assets and income resulted in $200 million judgment against the City to make whole actuarial losses created by the diversion.

K. **Municipality of Anchorage v. Gallion,** 944 P.2d 436 (Alaska 1997)

The Municipality of Anchorage had three retirement plans within its police and fire retirement system and had consolidated them for actuarial purposes. The first two plans had substantial surpluses to the extent that no further employee or employer contributions would be required for the life of the members of the plans. A third plan, which was still open was approximately 90% funded. The City passed an ordinance consolidating the plans for actuarial purposes, in essence

using the surplus in the first two plans to eliminate the need for contributions in the third plan. The members of Plans I and II sued claiming that the surplus money was theirs and could not be used to offset underfunding in Plan III. The court did not reach the issue of ownership of the assets but held instead that the loss of a separate actuarial valuation was a diminution of the constitutional, contractual right to benefits and ordered a separate valuation of each plan. The court also held that assets from one plan within a system could not be used to balance costs within another.

L. **Wisconsin Retired Teachers v. Employee Trust Funds,** 558 N.W.2d 1983 (Wis. 1997)

The state attempted to shift the cost of funding a COLA benefit from general state revenue to the excess earnings of the state retirement fund. A group of retirees whose COLA benefits were paid from these excess earnings and were adversely affected by the change filed suit claiming an impairment of the pension contract. The retirees also sued the trustees claiming a breach of fiduciary responsibility for not challenging the law. The court declared unconstitutional the attempt to utilize excess assets in the plan to pay a general state obligation but relieved the trustees of liability because they sought and followed the opinion of counsel.

M. **Association of State Prosecutors v. Milwaukee County,** 544 N.W.2d 888 (Wis. 1996)

Legislature passed a bill directing a uniform state retirement system. Prosecutors were changed from county employees to state employees. The bill allowed unvested employees to transfer employee and employer contributions from the county plan to the state plan. The state plan was a modified defined contribution plan and the county plan was a defined benefit plan. The transfer of the employees from the county to the state plan created an actuarial gain to the county plan. The county pension board refused to transfer the employer contributions claiming that they were part of the general actuarial benefit of the trust and were not attributable to individual members. The Supreme Court agreed that the law was an unlawful invasion of the pension trust and violated the exclusive benefit rule.

N. **Supreme Court Addresses Ownership of Excess Assets.**

The U.S. Supreme Court has reversed a Ninth Circuit Court of Appeals opinion in the private sector and has held that members of a defined benefit plan have a right only to their accrued benefit and have no claim to surplus assets even if those assets are partly attributable to the investment growth of their contributions. The Court held that a plan's actual investment experience does not affect a member's statutory entitlement to benefits but instead reflects the employer's risk. Since the employer has an obligation to make up any actuarial shortfall in the plan, members have no claim to any particular asset that composes a part of the general asset pool. Instead, members have a non-forfeitable right to accrued benefits which cannot be reduced below the guaranteed amount. The Court further held that if a plan becomes over-funded (assets exceed the actuarial or present value of accrued benefits) the employer may reduce or suspend its contributions. The Court also permitted excess contributions to be used to fund new participants in the plan who were participating in a non-contributory structure.

Hughes Aircraft Company v. Jacobson, 525 U.S. 432 (119 S.Ct. 755)(1999)

O. **Illinois Supreme Court Holds No Constitutional Right to Property Funded Pension.**

A group of employees sued the State of Illinois and various pension boards of trustees claiming a failure to adequately fund the retirement system. The employees claim that the boards and the state breached their fiduciary responsibility by failing to seek sufficient actuarial appropriations. The employees also claim that their pension contracts had been impaired and the state constitutional provisions protecting against diminution of pension plans was also violated.

The trial court dismissed the claims but they were reinstated by an appeals court. In reversing the appeals court and again dismissing the claims, the Illinois Supreme Court held that the employees have a right to receive a payment, not to a particular level of funding. Absent a

constitutional guarantee of funding, there could be no breach of fiduciary responsibility.

The Supreme Court noted that there was an absence of factual allegations that the failure to properly fund the plan had immediately imperiled the payment of benefits. Although the court did not reach the issue, it also hinted that the judiciary may lack the authority to order the legislature to appropriate money based on separation of powers.

Sklodowski v. State, 695 N.E.2d 374 (Ill. 1998)

P. **Federal Court Holds That Members Have No Right to Excess Assets.**

In the first Federal case addressing the rights of public employees in an overfunded plan, the U. S. Court of Appeals for the 8th Circuit held that a group of Iowa firefighters and police officers had no constitutionally protected right in the excess assets in their former local plans. In 1992, the State of Iowa merged its local police and fire pension plans into a single statewide system. The resulting merger left a number of cities with surplus assets from their former plans. The statute gave the cities the option of using the surplus fro their future contributions to the state system of giving those assets to members for their future contributions. The cities all opted to use the assets for themselves. The members claimed an ownership right in the assets and sued. The court held that no contractual right in the assets existed, only the defined benefits. The Court's analysis centered on that fact that since the employer takes the actuarial risk, that it should enjoy the benefits of overfunding.

Koster v. City of Davenport, 183 F.3d 762 (8th Cir. 1999)

Q. **Louisiana Supreme Court Upholds Constitutionality of Statutes Permitting Actuarial Committee to Set the Employer Contribution Rate.**

Several cities, represented by the Louisiana Municipal Association, filed suit against the Louisiana Firefighter Retirement System requesting a declaration that the employer contribution rate to the system was statutorily fixed at 9% and seeking an injunction preventing the state and the system from demanding more than the fixed 9% contribution rate. The lower court held the statutory provisions providing for funding

of the system were unconstitutional as applied. The Louisiana Supreme Court affirmed in part, reversed in part, and dissolved the injunction.

Louisiana Municipal Association v. State, 893 So.2d 809 (La. 2005)

R. **Closure of a Florida Plan Does Not Relieve Plan Sponsor Funding Obligation.**

In 2002, the Town of Lake Park entered into an inter local agreement with Palm Beach County transferring firefighting responsibility from the town to the county. As part of the agreement, the pension plan was terminated. The plan consisted of thirteen members. In connection with the termination of the plan, the pension board distributed plan assets in a lump sum to the membership. One firefighter, who was eligible for retirement, was paid a lump sum of the full value of his accrued benefit. Three firefighters, with ten or more years of service, received a portion of their accrued benefit. The nine remaining firefighters, with less than ten years of service, received no payment. The pension board demanded that the town pay $600,000 to the plan, representing the cost of the unfunded benefits for the twelve firefighters who received only partial or no benefits. The Town of Lake Park, Florida filed a complaint for declaratory judgment regarding its obligations to continue funding a terminated firefighter pension plan. Had the plan not been terminated, it would have been able to continue receiving state premium taxes on an annual basis until the plan became fully funded.

The trial court, ruling for the Town, reasoned that during the existence of the plan, the Town made all required contributions. The plan was managed by the board of trustees, who selected the method of lump sum distribution. The board followed the payment protocol set forth in the applicable statute. The termination statute provided for less than full payment to members, if the assets of the plan were inadequate to fully fund the plan. The statute created a priority for higher ranking categories of members, based on years of service. The court reasoned that if assets are exhausted by payment to higher ranking categories of membership, lower ranking members receive nothing. The court interpreted the statute to provide that a municipality has no obligation to continue funding a terminated plan under these circumstances.

On appeal, the Florida District Court of Appeals reversed, finding that state law was unequivocal on the obligation of a city to fully fund its retirement plan. The Court noted that the lump sum distributions criticized by the trial court were a lawful alternative for the board and did not provide a ground for the City to avoid its funding obligation.

Board of Trustees v. Town of Lake Park, 966 So.2d 448, (Fla. 4th DCA 2007)

S. **Walker v. City of Waterbury,** 2010 WL 114186 (2nd Cir. 2010)

The Union and The City of Waterbury ("the City"), negotiated terms of a new collective bargaining agreement ("CBA"). In the CBA, the Union made substantial concessions: pension benefits now accrued at 2% instead of 2.5%, the new CBA required 25 years of service before receiving full benefits, instead of 20 years, and firefighters who retired after the effective date of the new CBA had to make contributions to their health care premiums, whereas previous CBAs provided medical care at no cost. In return for these concessions, the Union received a promise that none of its members would be laid off during the term of the agreement and also procured a $4,000 lump sum payment to each firefighter over and above their normal salaries. A group of active firefighters and members of the Union claimed that the new CBA deprived them of benefits that vested under the previous CBA, which stated that each employee shall vest in his pension after ten years of service regardless of the reason for termination of employment. All of the firefighters reached ten years of service either under the previous CBA or in the interim between the expiration of that agreement and the ratification of the new CBA. The firefighters claimed that the denial of allegedly vested benefits violated the substantive component of the due process clause of the U.S. Constitution. The court granted the City's motion for summary judgment and the firefighters appealed. In order to sustain a substantive due process claim, a plaintiff must demonstrate that he was deprived of a fundamental constitutional right by government action that is arbitrary or that shocks the conscience. The firefighters argued that they enjoy a fundamental right to the specific pension benefits enumerated in the old CBA. They contend that, because they have "risked their lives in service of the public good," the pension benefits they expected to receive under that agreement were "fundamental in our society's understanding of the proper order of things." However, the court found that it is well-established that

substantive due process protections extend only to those interests that are implicit in the concept of ordered liberty, and rights so rooted in the traditions and conscience of our people as to be ranked as fundamental. Generally, interests related to employment are not protected. Simple, state-law contractual rights, without more, are not protected by substantive due process. The court concluded that the firefighters did not enjoy a fundamental right to the pension benefits they received pursuant to an ordinary employment contract.

T. **City of San Diego v. San Diego City Employees' Retirement System,** 111 Cal. Rptr. 3d 418 (Cal. Ct. App. 2010)

The City of San Diego established a program that allowed employees to purchase service credit in certain situations. It was undisputed by the parties that the program was intended to be cost-neutral to the city. After the board implemented the program, the city made retroactive benefit enhancements to the retirement plan, which effectively caused an increase in the value of prior service credit. However, the board failed to increase the cost of purchasing prior service credit. Several years later, in an effort to remedy the plan's growing actuarial liability, the board voted to charge the city for the unfunded liability. The court ruled that because the legislation authorizing the program provided that it would be cost-neutral to the city, the board exceeded its authority when it voted to charge the city for the underfunding.

U. **New Jersey Education Ass'n v. State of New Jersey,** 989 A.2d 282 (N.J. Super. Ct. App. Div. 2010)

A teachers' union filed a lawsuit against the state due to the state's failure to make appropriations for several years to fund the teachers' retirement system. Because state law requires the state to fund the pension system and the state failed to do so, the union argued that the state's failure to fund the system amounted to an unconstitutional impairment of contract. In rejecting the union's argument, the court held that union members do not have a constitutionally-protected right to a particular level, manner, or method of state funding of a pension system.

V. **<u>Professional Firefighters of New Jersey v. State</u>,** 2011 WL 3667721 (N.J. Super Ct. App. Div. 2011)

In a follow up to the NEA case, the New Jersey appeals court rejected a suit by firefighters and police officers contending that the intentional underfunding of the retirement system resulted in an impairment of their constitutional rights. The Court held that while vested benefits are protected, the manner in which the State chooses to fund those benefits is outside of the constitutional contract protections.

W. **<u>Wayne Cnty. Employees Ret. Sys. v. Wayne Charter Cnty.</u>,** 497 Mich. 36 (Mi. 2014)

The Wayne County Employees Retirement System ("retirement system") consists of five defined benefit plans, one defined contribution plan, and the Inflation Equity Fund (IEF). Each year, the county is required to make an "annual required contribution" (ARC). In 2010, Wayne County faced a substantial fiscal obligation in order to satisfy its actuarially determined ARC. To satisfy its ARC obligation, the county passed an ordinance amendment that limited the IEF to a maximum balance of $12 million, and directed that IEF funds exceeding that amount be transferred to the retirement system's defined benefit plans. The ordinance resulted in a transfer of $32 million from the IEF into the defined benefit plans. The amended ordinance further permitted the county to use the $32 million transfer from the IEF to the defined benefit plans as an offset against its ARC obligation. The retirement system challenged the 2010 ordinance amendment, claiming the transfer and corresponding ARC offset violated the Michigan Constitution and various provisions of the Public Employee Retirement Systems Investment Act (PERSIA). The Michigan Supreme Court held the transfer of funds from the IEF and offset against the county's ARC obligation violated the requirement of PERSIA that the funds be for the "exclusive benefit" of the retirement system's participants and their beneficiaries and that the county used the IEF funds in violation of the "prohibited transaction rule."

X. **<u>Burgos v. New Jersey</u>**, 118 A.3d 270 (N.J. 2015)

On June 9, 2015, the New Jersey Supreme Court, by a 5-2 vote, refused to enforce the funding provisions of a 2011 law (Chapter 78) hailed as a solution to New Jersey's long-standing pension funding

crisis. The majority decision by Justice LaVecchia held that notwithstanding Chapter 78's "historic compromise" and the Legislature and Governor's clear intent to create an enforceable contractual right to pension funding, "Chapter 78 cannot constitutionally create a legally binding, enforceable obligation on the State to annually appropriate funds as Chapter 78 purports to require."

The Court agreed with plaintiffs, a group of labor unions, that a "promise was made by the legislative and executive branches when enacting Chapter 78". The Court concedes that morally plaintiffs' argument is "unassailable". Yet, the Debt Limitation and Appropriations-related clauses in the New Jersey Constitution interdict the creation "of a legally binding enforceable contract compelling multi-year financial payments in the sizable amounts called for by Chapter 78."

Interestingly, the majority decision does not strike down or invalidate Chapter 78. Rather, the Court explains that, "we are not declaring Chapter 78 unconstitutional … Chapter 78 remains in effect, as interpreted, unless the Legislature chooses to modify it." Significantly, they did not hold that the promise to pay the obligation within seven years according to a prescribed formula was in and of itself unconstitutional. Only the promise to actually fund that obligation through an appropriation each year was held unconstitutional.

As repeatedly emphasized by the Court, appropriations should be determined annually by the elected branches of government who are accountable to the voters.

According to the Court:

The responsibility for the budget process remains squarely where the Framers placed it: on the Legislature and Executive, accountable to the voters through the electoral process. Ultimately, it is the people's responsibility to hold the elective branches of government responsible for their judgment and for their exercise of constitutional powers. This is not an occasion for us to act on the other branches' behalf.

The majority decision did affirm that the underlying right by members and beneficiaries to payment of retirement benefits remains intact:

We reiterate that there is no question that individual members of the public pension systems are entitled to this delayed part of their compensation upon retirement, but, as stated at the outset, that is not in question in the instant matter before this Court. That said, the State repeatedly asserted at oral argument that it is not walking away from its obligations to the pension systems and to pay benefits due to retirees.

Additionally, the Court acknowledged that the Legislature and Governor's well-intentioned efforts intended to create a contractual arrangement addressing pension funding "to promote the fiscal health" of the retirement systems. Likewise, the Court understood "the importance of maintaining the soundness of the pension funds" and bemoaned that "the loss of public trust due to the broken promises made through Chapter 78's enactment is staggering." But after narrowly focusing strictly on the legal question presented, the Court determined that the contractual pension appropriation provisions in Chapter 78 were not enforceable. In so holding the Court agreed that the case presented a "matter of great public importance to members of the public pension systems and citizens throughout the State."

The vigorous dissent by Justice Albin and Chief Justice Rabner observes, among other things, that the majority decision unfairly requires public workers to uphold their end of the bargain while allowing the State to shirk "its binding commitment" to fund the retirement systems. The dissent worried that public workers continue to pay into a system "on its way to insolvency." The dissent also chastised the majority's "cheery assurance" that there was "no question" but that each person's pension would have to be paid in full, since under the majority's ruling "the political branches . . . can let the pension fund run dry and leave public service workers pauperized in their retirement."

As a result of this decision, the New Jersey funding crisis remains unsolved and the state systems continue to edge toward insolvency. This problem was made even worse when, on June 30, the Governor vetoed the 2016 appropriation designed to reignite the Chapter 78 payment plan.

The unions sought review in the United States Supreme Court, which denied certiorari.

The Retirement Systems brought a separate suit to reduce the unfunded liability to a judgment which can be enforced under existing state law. The trial court dismissed that case in October 2015 and was affirmed by a mid-level appellate court in 2016. The state Supreme Court refused to review the case.

Y. In re Pension Reform Litigation (Heaton et al v. Guinn), 32 N.E.3d 1(Ill 2015)

In an emphatic unanimous decision, the Illinois Supreme Court reaffirmed that the pension protection clause of the Illinois Constitution "means precisely what it says," that membership in any state or local pension or retirement system "shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Article 8, Section 5 of the 1970 Illinois Constitution (hereinafter the "pension protection clause").

Senate Bill 1 was adopted in 2013 in the face of plummeting credit ratings and imperiled discretionary spending. It created a new payment schedule and a mechanism to allow the pension boards to initiate mandamus proceedings if the state fails to make required contributions. The centerpiece of SB 1 was a comprehensive set of benefit reductions including delaying retirement age by up to five years, capping maximum salary used to calculate benefits and replaced the flat 3% COLA with a variable formula. Almost immediately after SB 1 was signed into law it was challenged by five separate, consolidated lawsuits by current employees, retirees and their representatives. All suits challenged SB 1 as void and unenforceable under the pension protection clause. Other counts included impairment of contract, taking property without just compensation, and equal protection. Prior to taking effect, the circuit court entered a preliminary injunction staying implementation.

The state argued that the benefit reductions were justified by its "reserved sovereign power" and police power, given the unanticipated exigencies and the state's fiscal crisis during the Great Recession. The Court rejected this argument and held that the General Assembly does not possess inherent authority to override an explicit constitutional protection as a proper exercise of the police power. The Court also rejected the affirmative defense that the State's finances have been "so dire" that the State is compelled to invoke its reserved powers "in the

interests of the greater public good."

As recognized by the Court, for as long as there have been public pension systems in Illinois, there has been tension funding the chronically underfunded systems. Tracing the drafting history of the 1970 constitution, the Court quoted from the legislative history of the 1970 Constitutional Convention. Ultimately, the solution proposed by the drafters was to protect benefits not by dictating specific funding levels but by safeguarding the benefits themselves. According to the Court, Article 8, Section 5 protects pensions in two ways: by mandating that the pension relationship between the employer and employee is contractual and by preventing benefits from being diminished or impaired. According to the Court, while courts presume statutes to be constitutional, there is simply no way that the challenged benefit reductions can be reconciled with the rights and protections in the pension protection clause.

In the *Sklodowski* case in 1998 the Court had determined that the dual features of the pension protection clause served to "eliminate any uncertainty" as to whether state or local government was obligated to pay pension benefits to employees. Nevertheless, the Court was not willing at the time to allow members to sue to enforce funding discipline because the politically sensitive area of how benefits were to be financed was a matter left to the other branches of government.

In rejecting the state's argument 15 years later that the greater public good should prevail over pension protections, the Court noted that the circumstances in the case were not unique because economic conditions are cyclical and entirely foreseeable. While the General Assembly may find itself in crisis, it is a crisis that other retirement systems have managed to avoid and it is a crisis "for which the General Assembly itself is largely responsible." The Court also compared the 97% funded ratio of the Illinois Municipal Retirement Fund to the state plans funded at only 42%. The Court also noted that the state had other less drastic alternative which included adopting a new amortization schedule for unfunded liabilities, not allowing a temporary tax increase to lapse to a lower rate, and distributing burdens evenly among vendors and other creditors. According to the Court, "A crisis is not an excuse to abandon the rule of law. It is a summons to defend it. How we respond is the measure of our commitment to the principles of justice we are sworn to uphold."

The Illinois Supreme Court reached the same conclusion concerning the Chicago Pension Funds in Jones v. Municipal Employees' Annuity Fund, 2016 Ill 119618 (March 24, 2106).

V. WHAT IF I GET SUED?

A. Theories of Liability

1. Tort theory.

2. Contract theory.

    a. City of Riviera Beach v. Bjorklund, 563 So.2d 1114 (Fla. 4th DCA 1990)

        (1) Damages allowed only on contract theory.
        (2) Tort damages too speculative.

3. Civil Rights violation.

B. Defenses

1. Sovereign Immunity.
2. Good faith.

C. Insurance

1. Persons covered.
2. Claims covered.
3. Deductibles.
4. Exclusions from coverage.
5. Defense costs.
6. Selection of attorneys.
7. How to select an insurance policy.
8. 2007 Study performed by National Association of Public Pension Attorneys (NAPPA) provides an excellent resource.

D. Legal Defense

1. How to select?
2. Who is the client?

3. Conflicts of interest?

E. The Kentucky Retirement case

In late December 2017, a group of active and retired members of the Kentucky Retirement Systems (KRS) sued selected board members, current and former staff, the investment consultant, the outside investment counsel, and three hedge fund providers. The suit claims that the board of the consolidated systems was negligent in establishing a hedge fund of funds strategy. The complaint asserted that as a result of poor performance and excessive fees, KRS is drastically underfunded. The case is pending motions to dismiss in a state court in Frankfort, Kentucky.

VI. LOSS PREVENTION

A. Necessity of written contracts
B. Inclusion of fiduciary standards
C. Specification of responsibilities
D. Insurance
E. Resolution of disputes
F. Total agreement clauses
G. Pre-contract research

VII. PUBLIC PENSION FUNDS AS LEAD PLAINTIFFS IN SECURITIES LITIGATION

A. The Private Securities Litigation Reform Act of 1995**.**

This statute was adopted by Congress in 1995 to dramatically reform the manner in which securities litigation arising from insider trading and officer and director misconduct was handled. Prior to the Act, most securities litigation was handled by owners of small interest (often as little as one share) who fronted for law firms seeking early settlements in securities litigation yielding large legal fees. Congress' goal was to eliminate a race to the courthouse by the first plaintiffs and reduce the sway of lawyers over the management of securities litigation. The Act also had the purpose of enhancing recoveries in meritorious cases.

B. Investors Are Put in Charge**.**

In its conference report, Congress stated its intent that the lead plaintiff provisions of the Act encourage institutional investors to take a more active role in securities class actions. It was believed that by increasing the role of institutional investors in class actions that shareholders would ultimately benefit and the courts would be assisted by improving the quality of representation.

C. What Did Congress Think Institutional Investors Would Bring**?**

It was believed that institutional investors would bring sophistication, diligence and credibility to securities litigation. Under the Act, a party seeking lead plaintiff status is 60 days after notice that the first lawsuit has been filed. The purpose is to offer an opportunity to investigate, evaluate and decide the merits of the case. It also offers an opportunity to the court to select the most competent counsel to represent the class. Under the Act, there is a statutory presumption that the most adequate plaintiff will be the person or group of persons that in the determination of the court has the largest financial interest in the relief sought by the class.

D. How Does the Evaluation Period Work?

During the 60-day evaluation period a determination must be made as to whether a case is meritorious. Meritorious cases involve questions of fraud; misstatement of prior financial results; evidence that management knew of misstated results; and insider trading. Many cases are simply bad management as opposed to fraudulent behavior.

E. What Follows Application for Lead Plaintiff Status?

Within 30 days after a motion for lead plaintiff status is filed, the court is required to appoint as lead plaintiff the member or members of the purported plaintiff class that the courts determine to be most capable of adequately representing the interest of class members. In making this determination, courts look at the experience of the lawyers selected by the lead plaintiff applicant and often use that opportunity to set a maximum attorney's fee. In many cases, courts confronted with conflicting claims by qualified potential lead plaintiffs will often provide a bidding procedure among lawyers to secure the lowest possible

attorney's fee payable by the class. In such litigation, attorney's fees are paid by reducing the amount of the class award.

F. <u>Are There Restrictions on Pension Funds as Lead Plaintiffs</u>?

The Reform Act, in an effort to place restrictions on professional plaintiffs, provides that a person cannot serve as a lead plaintiff in 5 or more securities class actions during any 3 year period.

G. <u>Tellabs, Stoneridge, and the Future of Securities Litigation</u>**.**

In two major decisions in the last year, the US Supreme Court has restricted shareholder access to the courts. In the *Tellabs* case, the court set net, higher standards for pleading necessary to state a fraud case. In *Stoneridge Properties*, the court restricted the class of defendants who can be sued, substantially narrowing the class. Currently, the United States Supreme Court is considering a case which would require a higher standard of proof of the cause of an investment loss in order for cases to be certified as class actions. This case, involving *Halliburton,* currently requires that loss causation be proven before a class can be certified. NCPERS filed a friend of the court (*amicus curiae)* brief on behalf of the pension fund plaintiffs urging the 5th Circuit decision to be reversed. The Supreme Court agreed with NCPERS and reversed the court of Appeals.

H. <u>Backdated Options and Derivative Suits; Merger Suits</u>**.**

Shareholder derivative suits differ because they are suits brought by shareholders standing in the shoes of the company because directors and officers took actions contrary to the interest of the companies. The procedures differ greatly from federal class action suits and are frequently governed by state corporations law. Many fo these cases result in improved corporate governance which prevents officers and directors from misusing their authority for the gain of a select group of shareholders. Similarly, a number of suits have successfully challenged mergers and acquisitions which resulted in favorable treatment to existing management or corporate insiders to the detriment of the shareholders as a whole. The latest trend is in efforts through corporate by-laws to limit the ability to challenge officer and director misconduct. Through active efforts by public pension funds, those by-law efforts have been regularly defeated.

I. The *Morrison* Decision and Foreign Securities.

In 2010, the U.S. Supreme Court held in *Morrison v. National Australia Bank,* 130 S.Ct. 2869 (2010), that American securities laws have no remedy for foreign transactions. This has had a significant effect on American institutional investors who have increased foreign holdings in recent years. NCPERS is working to seek a legislative solution in light of current judicial decisions in light of Morrison that have severely restricted remedies.

J. CalPERS v. ANZ, 137 S.Ct. 2042 (2017).

A sharply divided US Supreme Court ruled 5-4 that the class action tolling rule relied upon by investors for over forty years applies only to the Securities Act's one-year statute of limitations, but not to its separate three-year "statute of repose." While not specifically addressed in the Court's decision, we expect that the reasoning of *ANZ Securities* will also be applied to the five-year repose period applicable to anti-fraud claims under the Exchange Act, as well as statutes of repose governing a variety of other federal statutes. The Supreme Court's opinion was authored by Justice Anthony Kennedy and joined by Justices Gorsuch, Thomas, Alito and Chief Justice Roberts.

Justice Ginsburg authored a forceful dissent, which was joined by Justices Breyer, Sotomayor and Kagan. The four-Justice dissent argued that CalPERS's individual claim "was timely launched when the class representative filed a complaint under [the Securities Act] on behalf of all members of the described class." This, the dissent argued, satisfied both the black letter text of the Securities Act statute of repose as well as its underlying purpose. The dissent was also highly critical of the policy ramifications of the majority's decision. "Today's decision disserves the investing public that §11 was designed to protect," the dissent declared, and "gum[s] up the works of class litigation" by forcing investors to file protective filings in many cases before the statutes of repose expire, which will have the effect of "increasing the costs and complexities of the litigation" for the court and all those involved.

The Supreme Court decision narrowing the tolling doctrine makes it necessary for investors to exercise heightened diligence to protect their rights on several fronts:

a. Faster identification of claims and enhanced case monitoring.

b. Filing of individual cases by separate suits or intervention motions.

c. Early case evaluation and recovery strategy.

NCPERS filed a friend of the court brief on behalf of CalPERS.

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K. Waggoner v. Barclays, 875 F.3d 79 (2d. Cir. 2017)

NCPERS led a group of institutional investors in a friend of the court (amicus curiae) brief on a case to preserve the fraud on the market presumption. The United States Court of Appeals for the Second Circuit Court issued an opinion on *Waggoner v. Barclays PLC*, No. 16-192-cv (2d Cir. Nov. 6, 2017), affirming the district court's decision to certify the case as a class action.

Investors have long relied on the "fraud-on-the-market" presumptions, a principle providing that the price of securities in a well-developed ("efficient") market generally reflects all publically available material information about the company. Therefore, if a material public misrepresentation about the company distorts stock prices, anyone who purchases stock at the distorted price is presumed to have relied on the misrepresentation. While the presumption has come under scrutiny in recent years, this decision is a huge victory for plaintiffs and institutional investors rights in general.

Among the most important points of the decisions, the court held that the plaintiff's burden to show market efficiency in order to benefit from the fraud presumption of reliance at class certification is light. Indirect evidence of market efficiency is sufficient to meet the burden. Additionally, should the defendants wish to rebut the presumption, they must do so by a preponderance of the evidence. Finally, the plaintiff's burden of proving that damages can be calculated on a class wide basis can be overcome without performing it in detail, but rather simple that the calculation is possible.

The NCPERS brief was a joint effort with Bernstein, Litowitz, Berger & Grossman; Klausner Kaufman Jensen & Levinson and Hank Kim.

VIII. DUE PROCESS

A. Defined

1. Constitution provides that property cannot be deprived without due process of law.

2. Due Process requires:

   a. Notice
   b. Opportunity to be heard
   c. Right to present evidence
   d. Neutral decision maker
   e. Decision based on evidence
   f. Findings and conclusions

IX. CONSTITUTIONAL ISSUES

A. Impairment of Contract

1. Both the US and various state constitutions make pension benefits a constitutionally protected property right.

2. The degree to which legislation may affect current employees varies from state to state.

3. No federal regulation of this issue because of 10th Amendment federalism concerns.

B. Application of ERISA Standards

1. ERISA prudent investor standards have specifically been made not applicable to state plans

2. Congress determined that the reserved powers clause of the 10th Amendment of the constitution prevented federal regulation of this traditionally state concern.

C. Recent Constitutional Cases

1. Florida Supreme Court Strikes Down Unilateral Reductions in Pension and Wage Benefits for Violation of Constitutional Right to Collectively Bargain.

In the summer of 2010, the City of Miami, faced with a budget crunch, used a little known provision of the state bargaining law called the "Financial Urgency" statute. The law allowed a public employer with serious financial troubles to accelerate the bargaining process. If the parties were at an impasse after that accelerated period, then the contract could be resolved in accordance with the impasse resolution process. Rather than follow that process, Miami simply altered the collective bargaining agreements substantially cutting wages and benefits. The unions filed unfair labor practices which were dismissed and the dismissal was upheld by a state appeals court. At the same time the City of Hollywood (Florida) did the same thing. The state labor board also ruled against the union, but a different state appeals court ruled for the union finding the City of Hollywood had violated the constitutionally- protected contract rights and bargaining rights of the employees.

Because of a conflict between two appeals courts, the Florida Supreme Court agreed to review the case. In a long awaited decision, the Supreme Court agreed with the unions. Florida is one of only a handful of states where collective bargaining for public workers is in the state constitution. The Supreme Court held that the actions of the cities violated the fundamental rights of contract and the right to meaningful collective bargaining. The Court held that the constitution was a limit on the power of government and the cities had exceed that limit. The decision invalidated the actions taken and has left the cities facing substantial damage claims for back pay and pension benefits.

Since the Supreme Court ruling, the Public Employees Relations Commission (PERC) has ordered a make whole-remedy, requiring restoration of all back pay and pension benefits. On October 27, 2107, the Florida Supreme Court dismissed the City appeal of the Hollywood case and applied Headley. The Pension Board reinstated the benefit formulas and the City sought an emergency injunction. That was denied in January, 2018. The City has appealed.

A challenge to the facial constitutionality of the law (the financial urgency law invalid in all circumstances) is currently pending in the Supreme Court of Florida.

Walter E. Headley Miami FOP Lodge 20 v. City of Miami, 215 So. 3d 1 (Fla. 2017)

B. <u>California Appeals Court Rewrites "California Rule</u>."

In an effort to respond to the rise of "pension spiking," the California Legislature enacted the California Public Employees' Pension Reform Act of 2013. The act made significant changes to how pension benefits would be calculated. Three separate decisions have arisen and are now consolidated for review in the California Supreme Court.

In the first case, three weeks after the act was passed, five labor unions together with a number of individuals currently employed by Marin County instituted an action against the Marin County Employees' Retirement Association (MCERA). On August 17, 2016, a state appellate court in San Francisco unanimously ruled that the Pension Reform Act was not unconstitutional as it applied to the plaintiffs' rights. While the main issue of the case was to prevent employees from boosting their benefits, the court went beyond the issue of spiking and addressed the broad constitutional protection provided by the California Rule, which prohibits virtually any changes from being made to pension benefits once they are given.

In 1983, The Supreme Court of California stated, in *Allen v. Board of Administration*, "Any modification of vested pension rights must be reasonable, must bear a material relation to the theory and successful operation of a pension system, and when resulting in disadvantages to employees, must be accompanied by comparable new advantages." In addressing this case, the appellate court determined that the court's meaning of "must" in *Allen* was not the literal meaning but rather that the court intended it be read as merely a recommendation.

According to the court, prior to retirement, the legislature may alter the calculation formula thereby reducing the anticipated benefits as long as the modifications don't deprive an individual of a "reasonable pension." As a result of the decision, the lines determining what constitutes a reasonable pension have been blurred. This could allow employers to

arbitrarily determine what is “reasonable.” This could potentially open the door to a surge of litigation. The California Supreme Court accepted review and is consolidating the matter with other similar pending cases.

Marin Ass’n of Public Employees v. Marin County Employees Retirement Ass’n., 2 Cal. App. 5th 674 (Cal. App. 2016).

The second case involved the question of whether elimination of the right to purchase five years of “airtime” was an unconstitutional violation of the contract clause and did not need to be accompanied by comparable new advantages. Legislature’s modification was reasonable and carried “some material relation to the theory of a pension system and its successful operation.”

Using a statutory analysis, the appeals court held that the Legislature would have specified that airtime was permanent, but didn’t. Court declined to add to the statute a promise not to modify or eliminate the airtime purchase option. The Court noted that CALPERS publications/statements were entitled to significant weight. Nevertheless, deferred to court precedent, not CALPERS literature describing the benefit as vested when an employee starts work.

Relying on *Marin County*, the court agreed members were entitled to a “reasonable” pension” and that *Allen* was not intended to be an inflexible standard.

Cal Fire Local 2881 v. CALPERS (First District, 3rd Div, 12/30/16)

In the third case, the issue was whether reduction in pensionable compensation (terminal pay; on call and standby pay; administrative response; bonus pay and one-time payments) is permissible. “[W]e are faced squarely with the question of whether those changes constitute a reasonable modification ... or whether their effect is to impair the vested contractual rights of” legacy members.

The appeals court affirmed in part and reversed in part, the lower court. The appeals court found that the trial court’s detailed analysis of the impact on legacy pensions was “incorrect in certain respects and also improperly failed to include a necessary vested rights analysis.” Reasonableness must be judged independently for each of the three systems, “in the context of each county’s particular CERL system.” The

appeals court found that the trial court never conducted a "systematic vested rights analysis." *Alameda* court more willing to allow estoppel.

Essentially, the appeals court disagreed with Marin and Cal Fire on the manner in which the constitutional analysis should be conducted and the weight of the evidence needed to justify a reduction.

Alameda County Deputy Sheriffs' Ass'n v. Alameda County Employees' Retirement Ass'n (First District, 4th Div, 1/8/2018):

C. After Years of Neglect, City Must Pay Up

In 1993, the Board of Trustees of the City of Harvey Firefighters' Pension Fund filed a complaint against the City of Harvey for failure to adequately fund the pension fund between 1988-1994 and failure to deposit levied and collected taxes into the fund. In 1996, the parties reached a settlement agreement that required Harvey to repay the amount due ($912,652) and Harvey ensured that in the future it would pay all taxes into the fund as required by the Code.

In 2010, 15 years after reaching this agreement, the Board of Trustees once again filed suit against the City of Harvey for failure to comply with the code, including breach of their 1996 settlement agreement. In their 2015 ruling, the Trial Court granted the Board's motions for declaratory judgment, injunctive relief and motion to compel enforcement of the settlement agreement. However, the Trial Court failed to find that the Board's finances rose to the level of the "verge of default or imminent bankruptcy" standard, despite the testimony of a number of individuals that the Fund would be unable to pay out benefits within the next five to ten years. This appeal followed.

Ultimately, the Illinois Supreme Court held that the City of Harvey must take responsibility for their complete lack of ability to properly manage its own finances as well as those of the Plan. Disagreeing with the Trial Court, the Supreme Court held, "Combining the ever-decreasing assets in the Pension Fund, the consistent lack of contributions, and the lack of evidence to support a changing of financial habits by Harvey, this court is convinced that the Pension Fund is on the verge of default." In addition to holding that the Fund was in a dire financial situation, the Court upheld the Trial Court's determination that the Code creates a valid and enforceable statutory right to funding. While the Code allows the City to exercise some discretion in its ability to change the funding formula, "Harvey must comply with the Pension Code in effect for any

given year. There can be no dispute that Harvey has completely failed to do this and that the discretion afforded [to] the City has been completely abused."

In disputing the Trial Court's final determination of damages, Harvey argued that the City should be responsible for only the amount reflected on the most recent actuarial valuation, and not a sum of the damages from the previously missed annual actuarial valuations. Additionally, the City argued that because an enrolled actuary didn't actually perform valuations for 2009, 2010, or 2012, as required by the Code, they should not be required to levy taxes for those years. The Supreme Court disagreed with the City's arguments, citing the Trial Court's reasoning, "if Harvey has actuarially funded the full amount in any fiscal year, the actuarial requirement for the following year would be lower because the unfunded liability would be lower." at 34.

Throughout their opinion, The Supreme Court stressed the overwhelming lack of effort by the City to make contributions to the fund, "in accordance with the specific levied amounts, or any reasonable amounts whatsoever." at 29. As a result of Harvey's total disregard for their responsibilities to the Pension Fund, the Fund is having to use its members' contributions in order to pay benefits. The Court recognized the dire state of the Fund and their opinion reflects the severe consequences that stem from a refusal by the City to adhere to the Pension Code.

In April 2018, a court refused to release state aid to the City because of its unpaid pension debt. In response, the City responded to the pension crisis by laying off half of its public safety employees.

Board of Trustees of City of Harvey Firefighters' Pension Fund v. City of Harvey, 739 N.E. 3d 636 (Ill. App. 2017)

X. <u>FIDUCIARY LIABILITY</u>

A. <u>Limits of Exposure</u>

Generally, public officials are not subject to personal liability unless they act willfully, wantonly and in reckless disregard of human life, safety and property. Such circumstances are never protected by waiver of immunity statutes because they are not considered conduct in the interest of the public good.

B. <u>Types of Claims</u>

Claims against retirement plans fall into several categories:

1. Contract Claims

The great majority of claims for denial of benefits are contractual in nature. Denial of benefits in essence involves an interpretation of the pension contract. Therefore contract law applies and damages are limited to providing the benefit which was denied together with interest

2. Civil Rights Violations

Failing to provide a plan member with a due process hearing before action is taken to deny benefits can result in a civil rights claim under the provisions of the federal Civil Rights Act of 1871, 42 USC §1983. This means that a member has been deprived of property rights (contract rights) without due process of law. Such claims can result not only in a make-whole remedy but also compensatory damages associated with the loss of the contract right. Punitive damages are not available against a state.

3. Tort Claims

It could be argued that if a member was misled as to rights under the plan through negligent misrepresentation that the fund could be sued for its negligence in explaining those benefits. The greater likelihood of a negligence claim is one which would arise from the negligent management of plan assets. While ERISA provides for liability exposure to trustees of private sector plans, such negligence claims against a government plan could be argued to fall within the state's governmental immunity statute. This would mean that employees and officers sued for negligent activity would be entitled to a defense and indemnity by the entity. Prior actions against the Board members have been dismissed under the state sovereign immunity statute.

4. Planning for Risk Avoidance

Risk avoidance is in most instances simply good advance planning. In a case for avoiding claims for denial of benefits arising out of evidentiary hearings, it is important to have a

written due process procedure. The due process procedure should provide notice, an opportunity to be heard and set forth a standard of proof. Trustees who will be deciding contested issues should not discuss the matter with the applicant or any other interested person prior to a hearing. All decisions should be based solely on the evidence presented at a hearing and the law applicable to the claim. All administrative orders and decisions should be reduced to writing setting forth in detail the reasoning of the trustees for their decision.

C. Suit Against State Retirement Plan Barred By 11th Amendment Immunity

A group of Michigan state court judges filed suit against the judicial retirement system and its trustees claiming denial of equal protection in that Detroit area judges received more favorable treatment than other state judges. In addition, the judges sued for common law trust violations and breach of fiduciary duty. A federal trial court dismissed the case on the basis that the retirement plan was "an arm of the State" and therefore immune from suit under the 10th and 11th Amendments of the U.S. Constitution. A federal appeals court sitting en banc (all 14 active judges) held that the federal suit was properly dismissed but the trial court should have allowed the plaintiffs to re-file their claims in the appropriate state court. The appeals court found that the question of whether a pension plan was an arm of the state was dependent on the degree of control by the state, the involvement of the state treasury, and the degree to which the plan constituted a traditional state function. The appeals court was careful to distinguish suits by individuals against a state from suits by the federal government against a state or suits by one state against another. The appeals court also noted that counties and cities do not enjoy the same immunity as a state.

Ernst v. Rising, 427 F.3d 351 (6th Cir. 2005)

D. Case Against Teachers Retirement System Dismissed on Standing and Ripeness Grounds

Texas courts issued the first decision on fiduciary duty and pursuit of investment policy. Although it is an unreported decision, meaning it has no precedential value, it nonetheless warrants some review. A member of the Teachers Retirement System brought a class action lawsuit against the system for violation of the takings clause of the Texas Constitution and breach of fiduciary duty. The member claimed that the

Teachers Retirement System and the trustees violated their constitutional duty to refrain from engaging in speculative investments. The Teachers Retirement System had published a financial highlight report for the 2008 fiscal year which demonstrated a loss representing a negative 4.5% total fund return for the year ending August 31, 2008, including a loss of $415,383,006.00 due to derivative investments. The member claimed that the derivative investments were considered speculative and should not have been made by the system and the trustees. The court ultimately dismissed the lawsuit based upon the doctrines of standing and ripeness. The court determined that since the system was a defined benefit plan, the member did not have standing because there was no real controversy between the parties as the defined benefit plan guaranteed benefits to all members. The court also held that the case was not ripe because an injury had not occurred to the members. The court did state that if the system denied any retirement benefits to any teachers, or the Texas Legislature increased mandatory contributions as a result of the investment loss, then at that time they may be able to state a claim. How this will relate to a cash-balance or hybrid plan is unknown. It would appear that to the extent a particular form of investment has no measurable impact on member account values, the same result would apply.

Ramon v. Teachers Retirement System of Texas, 2010 WL 1241293 (Tex. App. - Hous. April 1, 2010)(unreported)

E. The Efficacy Of Investment Decisions Made By Boards Of Trustees Is Not Subject To Judicial Review

Members of the Alabama Employees' Retirement System and Teachers' Retirement System brought class action against chief executive officer of the Retirement Systems, and officers and members of the boards of the Systems. Plaintiffs alleged defendants breached their fiduciary duties by investing in certain Alabama investments, which "have historically yielded lower returns than investments which could or should have been made in compliance with the mandates of the law, the Prudent Man Rule, and the Investment Policy of the Retirement Systems of Alabama (RSA)." The plaintiffs requested in their complaint that the trial court enjoin the RSA defendants from, among other things, investing "any assets" within their control in a manner not in accord with the "Prudent Man Rule" and from investing "in Alabama Investments ... which the [RSA defendants] expect or are aware will yield less of a return than alternative or other investments." The RSA defendants moved to dismiss on the basis of sovereign immunity, but the trial court

denied their motion, to which the RSA defendants appealed. The court first considered Alabama's codification of the "prudent investor rule," and articulated that the rule provided many considerations a trustee should consider, in addition to the rate of return on an investment. The "prudent-man rule" is a standard that allows for the exercise of ample discretion, providing general, guiding principles against which a court could assess a claim of personal liability or perhaps removal of a private trustee accused of making imprudent investment decisions.

However, the court held, the rule does not advance a specific duty that could serve as a basis for an order by the judicial branch to the executive branch to take certain action going forward. The court then considered whether, notwithstanding the difficulties involved in examining trustee investment decisions, the plaintiffs could overcome the wall of sovereign immunity to articulate a cause of action against the state. The court explained that the standard for liability and the standard for overcoming the bar of sovereign immunity are two different things. A plaintiff could question whether a State official acted with sufficient care or prudence in decision-making, but imprudence or lack of care is not a basis for overcoming the bar of sovereign immunity. Otherwise, the protection afforded State officials in making discretionary decisions would cease to exist. The court concluded that any oversight of investment choices made by RSA boards would be a task for which courts are not equipped. The "[l]ack of judicially discoverable and manageable standards" supports the conclusion that the making and oversight of such choices has been, and should be, left to a branch of government other than the judicial.

Ex parte Bronner, 2014 WL 7403996 (Ala. 2014)

F. Individual Members Of A Board Of Trustees Could Assert A Claim Against Fellow Board Members For Breach Of Duty

Trustees of the New Orleans Firefighters' Pension and Relief Fund filed a petition for mandamus to compel the City of New Orleans to make certain statutory contributions owed to the Fund. The City responded with a counter-claim against the Trustees, alleging they mismanaged the investments and assets of the Fund. The circuit dismissed the counter-claim as stating no cause of action and appellate court affirmed. Norman Foster, in his official capacity as Chief Financial Officer and Director of Finance of the City of New Orleans, wanted to amend the counter-claim to assert a cause of action as a statutorily named member of the Board of Trustees. In that capacity, Foster

asserted he had a statutory duty to remedy any breach by another trustee of which he had knowledge and should be allowed to amend his petition to state his cause of action. The LA Supreme Court held that because the city's counter-claim alleged various trustees breached their fiduciary duties to the Fund through their mismanagement, Foster, as a member of the Board and in accordance with his statutory duty of accountability, should be allowed to amend the petition independently to clearly state his cause of action in his capacity as a board member.

New Orleans Fire Fighters Pension & Relief Fund v. City of New Orleans, 157 So.3d 581 (La. 2015)

G. Texas Supreme Court Upholds Board Power to Resolve Disputes

The Texas Supreme Court has upheld the statutory right of a Board of Trustees to interpret the retirement plan. The City created a local government services corporation and transferred a number of city employees to the new corporation. The Municipal Employees Retirement System insisted that the transferred employees were still required to be members of the plan. The plan document allows the Board of Trustees to determine all questions concerning interpretation of the plan and the plan document, a state statute, provides that the Board's decisions are "final and binding." The employees and the City claimed the Board lacked the authority to make the decision that it did.

The Texas Supreme Court held that the decision of the trustees to retain employees in the plan was rationally related to their fiduciary duty to maintain the integrity of the System. The Court found that as a result, the Board's decision was authorized by its broad statutory powers and the Board's decision was "final and binding."

Klumb v. Houston Municipal Employees Pension System, 2015 WL 1276557 (Tex. 2015).

XI. ADMINISTRATIVE ISSUES

A. Rule-Making

Administrative agencies of government have the authority to make rules to interpret and apply the statutory authority under which they are created. Administrative rules may not exceed or grant powers not provided for by statute. Rule-making is particularly appropriate in the

pension area to ensure consistency of behavior. Pension funds should establish administrative rules dealing with the conduct of hearings; the conduct of day-to-day business; review of member benefit requests; investment policy and any other aspect of business not specifically provided for by the underlying legislation.

B. Ethics Rules

It is particularly important that trustees and fiduciaries of a retirement system avoid the appearance of impropriety. Under ERISA, there is a comprehensive set of prohibited transactions. No similar set exists for government plans. It is therefore important for the Retirement Board to identify conflicts of interest and address them. The general rule to follow is that "if it seems like it is wrong, it probably is."

C. Dealing With Vendors of Services

The area most fraught with potential conflicts of interest is dealing with providers of services to the retirement plan. Given the public scrutiny under which fiduciaries of government plans operate, it is best to avoid even an appearance of impropriety. This can be as simple as acceptance of a gift or gratuity which might otherwise be deemed an innocent gesture of friendship. It would be appropriate for the Board to adopt a policy regarding the acceptance of meals and other gratuities from vendors and to provide for a system of reporting. Further, it is extremely important that the fiduciaries of the Plan avoid direct contact with vendors during any bidding process. All communication should be through administrative personnel to avoid a suggestion or appearance that a contract for service has been awarded on anything other than the basis of merit. Reducing these rules to writing and providing for a method of reporting creates strong evidentiary support of the Board's adherence to important fiduciary principles of fair dealing.

XII. INVESTMENT ISSUES

A. Due Diligence

There are important factors to take into account in obtaining investment opportunities for the Retirement Plan. It must be remembered that the Trustees act as the fiduciary on behalf of the members and

beneficiaries of the Retirement Plan. All assets of the Retirement Plan must be used for the exclusive use and benefit of the members and beneficiaries and for defraying the reasonable cost of Plan administration. Prior to entering into any investment contract it is essential that due diligence be performed regarding the safety and security of the investment and its appropriateness for the Retirement Plan. The following checklist is recommended:

1. If the Plan is responsible for management of its own assets, this procedure should be followed.

2. The Plan should have a written investment policy setting forth the nature of permitted investments (stocks, bonds, real estate, etc.).

3. The investment policy should set forth the percentage of assets which may be placed in any one investment category, as well as the quality rating attributable to those securities (for example, government securities, investment grade securities, etc.)

4. The investment policy should set forth standards for performance for the investment managers.

5. There should be written contracts between the Plan and the investment manager setting forth the expected standard of performance of the investment managers, liability for failure to perform, fiduciary responsibility standard of the managers in a dispute resolution process.

6. The Plan should retain the services of an independent performance monitor to compare the performance of Plan assets against other standardized investment indices (for example, Dow Jones, S&P 500, Russell 2000, etc.). Investment manager reports should be received not less than quarterly. Indexing companies will often provide custom indexes to funds at no cost.

7. Performance monitor reports should be received not less than yearly. If the Plan is a defined benefit plan, the services of an enrolled actuary should be secured.

8. An actuarial valuation should be done at least every three years.

9. An experience study to test the accuracy of the actuarial assumptions utilized should be performed at least every five years.

10. The Plan should have an annual audit performed by a certified public accountant independent of the Plan sponsor. The accountant should also provide a management letter setting forth any observations concerning efficiency and security of Plan operations.

11. If the Plan is managed by a board of trustees, errors and omissions insurance may be secured.

12. The Plan should be represented by independent legal counsel.

13. Providers of service to the Plan should have written contracts setting forth duties, compensation, fiduciary obligations and a dispute resolution procedure.

14. An annual report should be made to the members and the Plan sponsor setting forth the annual performance.

15. A review of all SEC filings by asset managers should be made annually as part of continuing due diligence.

B. Prudent Investor Rule

The prudent investor rule is a general standard of trust law which requires investors to exercise a reasonable and prudent standard of care. It compares the behavior of a fiduciary to the expected standard of behavior of other similarly situated persons responsible for the investment of monies belonging to others. Many states have adopted statutory standards for fiduciary duty of investment professionals handling pension assets. While the rule is not codified under every state's, general trust principles will apply.

C. Reliance on Reports From Financial Advisors

It is extremely important that financial reports simply not be taken at face value without review and explanation. If the fiduciaries do not understand each investment opportunity in which the Plan is engaged, it is likely that it is not prudent to be so invested. Recent federal decisions held trustees in a private sector plan personally responsible

for plan losses attributable to their failure to question and understand the appropriateness of an investment for the plan. In that case, the trustees blindly accepted the performance report of the investment manager when it in fact was a substandard and inappropriate investment. The use of a performance monitor is the best protection against failing to apply prudent investor standards to the performance of the plan. In addition, it is advisable to pay an on-site visit to each prospective investment manager to ensure that their operation in fact is reflective of their promotional material. All promotional material should be retained for comparative purposes against the actual performance received. All contracts with investment managers should be severable without cause and without notice so that prompt action may be taken with regard to an underperforming investment manager. Investment contracts should also provide that if the manager procures an inappropriate investment for the plan which results in a loss that the investment manager shall be responsible for making whole any loss incurred.

Retirement funds have a fiduciary to protect the interest of their members. Most public retirement plans incorporate the prudent investor standard from the Employee Retirement Income Security Act of 1974 (ERISA) (26 United States Code, Section 1104). While ERISA does not apply to plans maintained by state or local government entities, the ERISA standard of acting as a prudent investor has been adopted. Armed with the knowledge that a mutual fund, or any investment professional, has compromised the integrity of the retirement fund, the Board of Trustees has a duty to act and replace the manager.

D. What Can an Institutional Investor Do to Protect Itself?

There are a number of steps in light of the recent revelations of Wall Street misconduct that institutional investors can do to protect themselves:

1. Ask all investment managers for a statement of their compliance policies with SEC rules.

2. Direct communication with managers, beginning with the selection process.

3. Adding contractual penalties for SEC rule violations.

4. Require immediate notice of any SEC or other investigation of company trading practices.

5. Provide for return of fees in instances of fraud or breach of contract.

6. Adopt investigatory policies as part of the investment policy.

7. Remain current on news issues.

8. Trustee education.

9. Taking an active role in securities litigation class actions as outlined above.

E. What Should Defined Contribution Plan Participants Be Doing**?**

1. Fund selection must operate on the same fiduciary principles as in the defined benefit plan.

2. Member education and communication.

3. Enhanced reporting.

4. Careful review of plan prospectus.

F. Investment Decisions Illustrating the Theme

1. New Mexico teachers were held to lack standing to recover 2008 investment losses. During the national economic crisis in 2007-2008, the New Mexico Educational Fund ("Fund") lost approximately $40 million on certain private equity investments. The Fund holds approximately $8.5 billion in assets used to pay benefits for 95,000 teachers and other participants. Teachers brought suit against the Fund, Board members and investment advisers for breach of fiduciary duty, violation of federal and state securities laws, aiding and abetting breach of fiduciary duty, and breach of contract. Plaintiffs alleged that they were injured by defendants' improper investments due to potential increased employee contributions, reduced services, tax increases, and the increased risk that the Fund would not have sufficient assets to satisfy its obligations in the future. The court held that plaintiffs could not show that their benefits were threatened, that the

system was currently underfunded, or that the challenged investment caused the underfunding.

The court recognized that altering retirement eligibility or contribution requirements would require the legislature to act. Under these circumstances, plaintiffs lacked standing to sue. Plaintiffs' allegations that they faced the risk of tax increases, potential future benefit reductions or increased contribution levels, and that they were injured by the loss of principal, income, fees, and expenses did not establish an injury in fact fairly traceable to the defendants.

State governmental entities, including public employees/trustees acting within the scope of their duties, are immune from liability for any tort, except as waived by law. The court held that breach of fiduciary duty is not one of the tort claims for which the New Mexico legislature chose to waive governmental immunity under New Mexico's Tort Claims Act. After granting the motion to dismiss in part, the federal district court remanded the case to New Mexico state court given a lack of subject matter jurisdiction.

Hill v. Vanderbilt Capital Advisors, 2011 WL 6013025 (D.N.M 2011)

2. In *General Retirement System of the City of Detroit v. UBS*, 2010 WL 5296957 (E.D. Mich. 2010), the retirement system sued UBS alleging that the latter fraudulently induced both the general and public safety pension funds into buying an equity position in collateralized loan obligations and for breach of fiduciary duty. The suit was filed in Wayne County, Michigan state court. UBS removed the case to federal court on the basis of diversity of citizenship. The retirement plans sought to remand the cases back to state court claiming that each had retiree participants residing in Delaware and Connecticut. The federal court declined to remand the case finding that the residency of the pension funds, as the legal owners of the assets, controlled rather than the citizenship of individual participants.

3. By contrast, in May 2011, the United States Court of Appeals for the 8th Circuit remanded a securities fraud case back to state court in *Public School Retirement System v. State Street Bank and Trust*, 640 F.3d 821 (8th Cir. 2011). As State Street was a

citizen of Massachusetts, it removed the case to federal court from the state court in Cole County, Missouri, the county where the retirement plan was headquartered. The retirement plan moved to remand the case back to state court claiming it was immune under the diversity of citizenship statute. The appeals court found that the retirement plan was an arm of the state of Missouri. As such, the system was not a "citizen" within the definition of the federal law providing for jurisdiction between citizens of different states. Apparently, the deciding factor was the state treasury's exposure to costs of the retirement system.

G. The IRS Takes an Interest in Certain Investments

1. A state set up a non-profit corporation for the purpose of financing the state's utility infrastructure from damage caused by natural disasters. The agency was designed to issue taxable bonds and to cause the bond cost to be levied against utility customers. The question was whether the receipt of these funds would constitute taxable or tax-exempt income. The IRS found providing lost cost capital to utility companies to repair their facilities following a natural disaster and the receipt of transferred rights to collect the loan proceeds from customers was an essential governmental function and exempt form taxation under IRC Section 115. PLR 200808025 (2008).

2. Similarly, a non profit corporation was formed consisting of local subdivisions of the state to identify, serve, and promote the interests of its members and state residents regarding development and distribution of state water resources. The Association derives its income from membership dues and conference fees. It also provides for property and liability risk pools for members as well as employee benefits for its employees. The IRS found the purpose of the association as it related to water resources to be an essential governmental function and exempted its income from taxation under IRC Section 115. PLR 200807001 (2008).

H. **Board's Response to Recession May Have Breached Their Fiduciary Duty.**

County employees brought action against their employee retirement association for breach of fiduciary duty and a violation of the County Employees Retirement Law (CERL), specifically in regards to a

provision governing the computation of the normal contribution rate. As a result of the 2008 recession, The Stanislaus County Employees' Retirement Association (StanCERA) implemented several changes to the actuarial calculations that are used to determine how to amortize unfunded liabilities within the system. Each party filed a motion for summary judgment, and the trial court concluded that none of the actions taken by the Board were unconstitutional and finding no material issue of fact, awarded summary judgment to StanCERA.

Faced with financial struggles, StanCERA decided to change the amortization schedule for unfunded liabilities to a 30-year level percent pay rather than the 20-year level dollar amortization initially proposed. In addition, the Board transferred approximately $80 million from the non-valuation Health Insurance Reserve to the valuation reserves.

On appeal, the court determined that although the employees were not entitled to summary judgment, there were remaining issues of material fact. Ultimately, the court concluded that the trial court erred in granting summary judgment to StanCERA and the County. While many facts detailing the Board's conduct are not in dispute, "there remain material issues of fact whether the resulting conduct violated the constitutionally mandated fiduciary duty of loyalty the Board owed to StanCERA's members.

O'Neal v. Stanislaus County Employees' Retirement Association, 8 Cal.App.5th 1184 (2017)

I. **Kentucky Appeals Court Rejects Sovereign Immunity Claim by Retirement System**.

Kentucky Retirement Systems (KRS) was sued in a class action by a participating city claiming the Board engaged in various improprieties in the choice of alternative investments and in the payment of allegedly excessive management fees. The cities complained that KRS should not have purchased unregistered securities. The complaint sought a declaration that the Board had violated its fiduciary duty. In addition the suit sought to prohibit the use of KRS assets to pay the management fees and an accounting. The Board moved to dismiss on sovereign immunity grounds and a trial court denied the motion. On appeal, the Kentucky Court of Appeals held that sovereign immunity did not bar the suit because no monetary damages were sought. The court also found that the ability of KRS to sue and be sued acted as a waiver of immunity for non-monetary damage suits. The order denying the

motion to dismiss was affirmed and the case permitted to proceed. The case remains pending.

Board of Trustees v. City of Fort Wright, 2016 WL 5319180 (Ky. App. 2016)

XIII. TAX ISSUES

Tax Treatment of Disability Benefits

A. General Terms

1. Service-connected disability benefits are generally non-taxable if the benefit is not determined by reference to an employee's age or length of service.

2. Duty-related benefits paid where the disability is presumed to have occurred in the line of duty and the presumption is rebuttable are non-taxable.

3. Duty-related benefits paid where the disability is presumed to have occurred in the line of duty and the presumption is not rebuttable are taxable.

4. Non-service disability benefits are taxable as ordinary income.

5. Service disability benefits which are deemed non-taxable only become taxable if there is a provision in the plan requiring conversion of the disability benefit into a normal retirement benefit. Otherwise, disability benefits remain non-taxable for life.

B. Applicable Tax Code Provisions

1. Section 104(a)(1) of the Internal Revenue Code provides that gross income does not include amounts received under Workers' Compensation acts as compensation for personal injuries or sickness.

2. Section 1.104-1(b) of the Income Tax Regulations provides that Section 104(a)(1) of the Code excludes from gross income amounts received by an employee under a Workers' Compensation act or a statute in the nature of Workers'

Compensation act that provides compensation to employees for personal injuries or sickness incurred during employment. Section 104(a)(1) does not apply to a pension to the extent that the pension is determined by reference to an employee's age or length of service or the employee's prior contributions. See also, IRS Private Letter Ruling 9625026 and 200116040.

C. Presumptive Disease

Case law, tax court decisions and private letter rulings treat the tax consideration of disability benefits granted under a presumptive disease clause differently based on whether the presumption is rebuttable. Disability benefits provided to a member where the presumption of the disease or injury is rebuttable are considered non-taxable. Occupational disability benefits granted where the presumption is irrebuttable are taxable on the basis that the benefit is deemed an early service retirement. See, **Take v. Commissioner of Internal Revenue Service, 804 F.2d 553 (9th Cir. 1986); Private Letter Rulings 9731018, 200116040 and 9625026. See also, Revenue Ruling 85-105.**

D. Disability Benefits Received at Age 65

Service-connected disability benefits which are payable for life remain tax-free for life. The fact that an employee reaches Social Security eligibility does not affect the retirement income. In Private Letter Ruling 8742039, the IRS was asked whether disability income payments from an employer to its firefighters and police officers that were otherwise excluded under Section 104(a)(1) of the Internal Revenue Code became taxable when the recipient reached age 65. Under the terms of the plan discussed in the request, disability payments were for life and were not converted to a normal retirement benefit upon a certain event. The IRS ruled that the disability benefits remained non-taxable for life. By contrast, the IRS ruled that non-taxable disability benefits which convert to a normal retirement benefit at a later date become taxable upon the date of the conversion. See IRS Revenue Ruling 80-14.

Section 415 Regulations

A. General Rules

The IRS has adopted regulations relating to benefit and contribution limits under Section 415 of the Internal Revenue Code (IRC). The regulations are complex and in some instances substantially alter the treatment of maximum benefit and contribution provisions.

B. For Defined Benefit Plans

The employer-provided portion is limited to a specific dollar amount which is annually indexed for inflation. For 2015, the maximum in rounded numbers is $210,000. For public safety employees (police and fire) with a minimum of 15 years of service, the dollar limit is the maximum permitted by law. For all other governmental employees, the maximum amount is actuarially reduced below age 62, except for disability and death benefits. The employer provided portion includes pick-up contributions but excludes mandatory after-tax contributions.

C. Cost-of-Living Adjustments

COLA payments need not be included in the 415 calculation if certain conditions are met.

D. The COLA Conditions Are:

1. The plan must limit the benefit paid to no more than the 415 limit for that year.

2. The form of benefit may not be subject to 417(e) - this means lump sum distributions such as PLOPs and possibly DROP's and BackDROP's.

3. It is recommended by the IRS that the increased 415 index be expressly included in the plan document.

E. Treatment of DROP for 415 Purposes

One of the biggest challenges to deferred retired option plans (DROP) is whether the IRS will treat them as defined benefit or defined contribution benefits within a DB plan.

In order to determine the proper treatment of the allocation of DROP and BackDROP accounts, the IRS has issued guidance. The IRS has approved the request of one retirement plan using the formula described in this outline.

For BackDROP, the IRS says that even if paid in a lump sum, the amount paid is to be annuitized according to the table in Section 72 of the IRC. The annual amount is added to the annuity going forward. If the sum does not exceed the 415 limit, no reduction is required.

In the case of a regular forward DROP, the underlying benefits are measured against the 415 limit. At the end of the DROP period, the DROP account is annuitized in the same way as the BackDROP would be and added to the annual forward annuity. If the sum of the two pieces exceeds the 415(b) limit the annuity is reduced to the maximum and the remaining amount must be paid through an excess benefit arrangement. IRS PLR 200721022 (2007).

The issue now presented is whether a DROP benefit which is at risk to the market meets the "definitely determinable benefit" rules of the Tax Code. Many DROP plans offer a variable rate of return based on overall plan performance. This can result in a return of "less than zero" and actually make a DROP account worth less than if the member had never entered DROP.

In December 2014, the IRS issued an advisory memorandum to its field representatives (which is not an official, binding policy statement of the agency) concerning DROP plans with both fixed rates of investment return and those with variable rates. A "fixed rate" DROP was not considered subject to Section 415 (c) defined contribution (DC) limits, but was considered the deferred receipt of a defined benefit. A fixed rate was defined as a specific rate of return (such as 5%); a maximum or minimum rate (such not more than 10% nor less than zero); or an interest selected by the participant.

While this appeared to relieve much of the anxiety that variable earning rates violated the "definitely determinable benefit" rule contained in the Internal Revenue Code, later action by the IRS National Office in late January issued informal guidance that the December memo only settled the question of whether a DROP was considered a DC plan or a DB plan. The question of whether a DROP structure in a particular plan violated the definitely determinable rule apparently remains in play.

After this guidance, scores of letters were received by plans seeking tax qualification letters asking how the DROP interest was being calculated. The later guidance appears to have been geared toward alleviating a backlog of plan determination letters where DROP was a feature.

In one response by a plan which had both a "risk free" bond option and a "return of the plan option," the plan took the position that earlier IRS Revenue Rulings (73-448 and 71-24) and Private Letter Ruling 8203066 provided that variable risk in a trust after the employer stopped contributing did not violate the definitely determinable rule.

F. IRS Outlines Formula for Establishing Tax Exempt Post Retirement Health Trust

The IRS analyzed a municipal trust established to provide post retirement health care benefits to retired employees and their families. Participation is mandatory. The plan consisted of mandatory employer contributions, mandatory employee contributions and mandatory transfer of accumulated, unused leave. Benefits were payable for health insurance and other post retirement medical expenses. Upon the death of the member, the spouse or other dependent as defined in the IRC could continue to receive the health care benefit. Upon the death of the survivors, any amount left to the credit of an employee was forfeited to the trust for general trust and could not be otherwise transferred or inherited. If the trust is terminated, the employer will receive a reversion of the trust assets. The IRS held that the employer and employee contributions were excludable from income to the members under section 106 of the Code, as were distributions of benefits. In addition, the investment income of the trust were excluded from income because the trust performed an essential governmental function. **The key feature is the non-discretionary operation of the contribution formula, thereby eliminating constructive receipt issues. PLR 200802003 (2008).**

G. Definition of "Governmental Plan" under IRC 414(d)

On November 8, 2011, the IRS issued an advance notice of proposed rulemaking on the definition of "governmental plan" under IRC '414(d). By issuing this notice, the IRS is requesting input from the governmental community in order to supply comprehensive guidance that is practical and administrable. According to the notice, the IRS is considering the following main facts and circumstances to determine whether an entity's employees are eligible to participate in a governmental plan:

1. The entity's governing board or body is controlled by a state or political subdivision. The members of the entity's governing board or body are publicly nominated or elected.

2. A state or political subdivision has fiscal responsibility for the general debts and other liabilities of the entity, including the responsibility for the funding of benefits under the entity's employee benefits plans.

3. The entity's employees are treated in the same manner as employees of the state or political subdivision for purposes other than providing employee benefits.

4. The entity is designated the authority to exercise sovereign powers, which generally means the power of taxation, eminent domain or police power.

The proposed rules have posed potential issues for charter schools, particularly those run by for-profit entities; hospitals that are affiliated with non-profit or religious entities but which are deemed public hospitals; and joint operating agreements among utilities which are partnerships between public entities and shareholder-owned companies.

The IRS did issue Notice 2015-07 did propose rule making find charter schools to be governmental and eligible to be in a public retirement system if chartered by a government and its primary funding is governmental. The proposed rule is still subject to public input through May 11, 2015.

H. <u>Effect of the Loss of "Pick-up" and Other Sheltered Contributions on Benefit Administration</u>

A California county has a defined benefit (DB) plan where gains and losses are shared between the sponsor and the participants. This means the employee contribution is not fixed and has risen at the same rate as the employer contribution. In response to this impact on the employees, a second tier was negotiated with a lower DB benefit and a fixed contribution.

The new plan is optional. New hires can elect the current plan or new plan. Current employees may opt for the new plan as well. Presumably, a dramatic shift from the current plan to the new plan will reduce projected future liabilities in the current plan, thereby improving its funded status and lowering employer costs. The lower benefit will also fit the political climate concerning what is viewed by many as "too generous" DB benefits. By making the choice voluntary, the employer avoids any constitutional issue of diminution of benefits. It could also have the effect of hastening the closure of the current plan, leaving only a reduced DB retirement.

The “problem” arises from a request by a union (not the one involved in the negotiations) wanting to ask the IRS to disapprove continuing “pick up” contributions in the new plan for anyone who can elect participation. The theory is that the loss of the “pick up” will force the employer to back away from the second tier plan. The loss of the “pick up” will create a potential constitutional impediment to the plan.

The bigger issue is that the union requesting the IRS opinion has invited the IRS to apply ERISA regulations to governmental plans. This could seriously blur the line between IRS regulation of private and public sector plans. The following issues have been presented to the IRS in response to the interest in this issue:

1. Many states and cities have or are in the process of imposing benefit reductions for current and future employees. Because of state constitutional limitations, choice is being offered to current employees. The loss of the pick-up would create a state constitutional issue as the plans also require “tax qualification.” The case law says that loss of favorable tax status is a loss of a benefit and would create the question of whether benefit amounts need to be increased to make up the loss.

2. In further discussion of the above, the pressing economic necessity of second tiers of benefits depends in part on the election of current members to transfer plans for a meaningful cost impact to be felt immediately. The loss of the pick-up will have the effect of lowering the disposable income of plan members at the same time they are facing unilateral salary reductions. This will directly impact on thousands of collective bargaining agreements, creating the high risk of multiple lawsuits and state unfair labor practice proceedings. Litigation is already pending on related benefit reduction issues in Florida, Minnesota, South Dakota, Colorado, California, Maryland and Louisiana.

3. Pick-up contributions/tax sheltered contributions are widely used in portability of benefits. Numerous states (Maryland, California, Louisiana, Texas, for example) require reciprocal service among plans. The loss of tax sheltered plan-to-plan transfers would effectively invalidate those provisions.

4. USERRA and comparable state veteran’s preference laws permit the purchase of military time. Some states require the time to be granted. The inability to use sheltered contributions will effectively eliminate the ability of most returning veterans to receive the retirement benefits

which Congress and the various state legislatures have mandated be made available.

5. In order to attract and retain employees, the ability to purchase prior governmental service is increasing. While many states have intra-state portability statutes, there is no inter-state portability. The use of sheltered contributions enables public employees to be able to purchase prior governmental service as permitted by law. The loss of the tax sheltered option would effectively place the cost of this statutory right beyond the financial reach of the intended beneficiaries of that legislation. Most public safety plans allow purchases of prior police or fire service, provided the service is not otherwise being used for a retirement in another jurisdiction for the same kind of service. A number of jurisdictions also have "time connections." This allows employees with broken service for government to connect the time for vesting purposes. This has been particularly important in jurisdictions suffering shortages of highly trained personnel such as educators. Again, costs are generally borne with sheltered contributions.

6. State and local government employers are increasingly looking to reduce payrolls by encouraging employees to buy "air time" to the extent permitted by law. This enables them to separate workers from governmental payrolls and allows orderly reductions in force without age discrimination exposure. At the same time, pension benefits will be lower than projected without material harm to the economic welfare of the retiring employees, thereby easing economic stress on retirement plans and plan sponsors.

7. Many of the benefits outlined above are committed to multiple payees as a result of various state court judgments of divorce or dissolution of marriage. Particularly in community property jurisdictions, the loss of sheltered contributions will affect the economic value of marital estates, many of which were settled years ago. This will result in the reopening of untold thousands of domestic relations judgments and will create substantial chaos in personal property rights of both members and alternate payees.

8. There is great concern that a change in the treatment of contributions will affect involuntary transfers of accumulated leave to the purchase of service credit and deferred retirement option (DROP) accounts. In accordance with prior IRS rulings, accumulated leave is no longer "elective" in terms of cash payment. Instead, many jurisdictions, particularly those affected by the disallowance of the ICMA leave program, made distribution of accumulated, unused leave, a mandatory

non-cash distribution. Again, settled retirement and collective bargaining rights will be at risk for substantial and irreconcilable chaos.

9. The effect of the loss of sheltered contributions will adversely affect the hundreds of DROP, Back DROP, and Partial Lump sum option (PLOP) arrangements. This will result in a substantial reduction in the value of retirement benefits placing the plan sponsors at odds with their constitutional obligations prohibiting impairment of contract.

10. The extent to which all of the above has the direct effect of invalidating state and local government retirement plan provisions, collective bargaining agreements governed solely by state public bargaining laws, and the resulting effect on state and local government budgets which are already under severe financial stress, unequivocally implicates federalism under the 10th Amendment of the United States Constitution.

XIV. NORMAL RETIREMENT AGE FOR IN-SERVICE DISTRIBUTIONS

A. In-Service Distribution and IRS Bulletin 2016-17

1. Announced in January and issued on February 16, 2016.

2. Maintains a safe harbor age of 62 but added additional measures.

3. Non-Public Safety Measures

    a. Age 60 with 5 years.

    b. Age 55 with 10 years

    c. Rule of 80

    d. 25 years at any age

4. Public Safety

    a. Age 50

    b. Rule of 70

    c. 20 years at any age

5. Facts and circumstances test still available

B. The Full Text of the Proposed Regulation

§ 1.401(a)–1 Post-ERISA qualified plans and qualified trusts; in general.

* * * * *

(b) * * *

(2) * * *

(v) Rules of application for governmental plans—(A) In general. In the case of a governmental plan (within the meaning of section 414(d)) that provides for distributions before retirement, the general rule described in paragraph (b)(2)(I) of this section may be satisfied in accordance with paragraph (b)(2)(ii) of this section or this paragraph (b)(2)(v). In the case of a governmental plan that does not provide for distributions before retirement, the plan's normal retirement age is not required to comply with the general rule described in paragraph (b)(2)(I) of this section or this paragraph (b)(2)(v).

(B) Age 60 and 5 years of service safe harbor. A normal retirement age under a governmental plan that is the later of age 60 or the age at which the participant has been credited with at least 5 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(C) Age 55 and 10 years of service safe harbor. A normal retirement age under a governmental plan that is the later of age 55 or the age at which the participant has been credited with at least 10 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(D) Sum of 80 safe harbor. A normal retirement age under a governmental plan that is the participant's age at which the sum of the participant's age plus the number of years of service that have been credited to the participant under the plan equals 80 or

more is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. For example, a normal retirement age under a governmental plan that is age 55 for a participant who has been credited with 25 years of service would satisfy the rule described in this paragraph.

(E) Service-based combination safe harbor. A normal retirement age under a governmental plan that is the earlier of the participant's age at which the participant has been credited with at least 25 years of service under the plan and an age that satisfies any other safe harbor provided under paragraphs (b)(2)(v)(B) through (D) of this section is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. For example, a normal retirement age under a governmental plan that is the earlier of the participant's age at which the participant has been credited with 25 years of service under the plan and the later of age 60 or the age at which the participant has been credited with 5 years of service under the plan would satisfy this safe harbor.

(F) Age 50 safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is age 50 or later is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)).

(G) Sum of 70 safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is the participant's age at which the sum of the participant's age plus the number of years of service that have been credited to the participant under the plan equals 70 or more, is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)).

(H) Service-based safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is the age at which the participant has been credited with at least 20 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)). For example, a normal retirement age that covers only qualified public safety employees and that is an employee's age when the employee has been credited with 25 years of service under a governmental plan would satisfy this safe harbor.

(I) Reserved.

(J) Other normal retirement ages. In the case of a normal retirement age under a governmental plan that fails to satisfy any safe harbor described in paragraph (b)(2)(ii) of this section or this paragraph (b)(2)(v), whether the age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed is based on all of the relevant facts and circumstances.

(vi) Special normal retirement age rule for certain plans. See section 411(f), which provides a special rule for determining a permissible normal retirement age under certain defined benefit plans.

* * * * *

(4) Effective/applicability date. * * * In the case of a governmental plan (as defined in section 414(d)), the rules in paragraph (b)(2)(v) of this section are effective for employees hired during plan years beginning on or after the later of: January 1, 2017; or the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after the date that is 3 months after the final regulations are published in the Federal Register. However, a governmental plan sponsor may elect to apply the rules of paragraph (b)(2)(v) of this section to earlier periods. * * *

C. Why Does this Matter?

1. Large numbers of employers are rehiring retirees without a true break in service.

2. In such cases, where employees are also receiving retirement benefits, an “in service distribution” issue is presented exposing the rehired employees to early distribution penalties under Code Section 72.

D. A Discussion of “Independent Contractor” vs. Employees

1. The difference “fact dependent.”

2. The IRS has established a 20 part test.

3. Most rehired retirees are not contractors

XV. SECTION 72 AND EARLY DISTRIBUTION

A. What Does Section 72 Provide?

1. If a benefit distribution is given to a member who separates from service prior to a certain age, there is a 10% penalty in addition to any ordinary income tax on the benefit.

2. The Pension Protection Act lowered the age for public safety employees to age 50 if the employee separated from service in or after the year in which the employee attained age 50. In such cases, the penalty does not apply.

3. For other public employees the penalty does not apply if the employee separated in or after the year in which they attained age 55.

4. If the employee separated prior to these dates, the early distribution penalty applies until attainment of age 59 ½.

B. Does This Affect DROP distributions?

1. If the DROP account is converted to an annuity based on life expectancy, there is never an early distribution penalty.

2. Regular retirement payments in substantially equal payments for life do not incur the penalty.

3. A rollover to an IRA or other qualified plan is not a distribution, but, once rolled over, is governed by age 59 ½.

XVI. IS DROP A DB PLAN OR A DC PLAN, WHY DOES IT MATTER?

A. The IRS has opined that DROP is not a separate DB plan; it is a distribution method within a DB Plan.

B. When DROP is distributed, the plan actuary must calculate the DROP is if was an annuity payable over the life of the member. The value of that hypothetical annual payment is added to the annual forward retirement benefit. If the sum of the two equals or exceeds the limit in Section 415(b) of the Internal Revenue Code, there must be an excess benefit arrangement to pay the difference.

C. The Tax Code limitations only relate to what the plan can pay; it is unrelated to the obligation of the employer to pay the full benefit earned. That obligation is a matter of state constitutional law.

D. If DROP was a DC plan, the maximum amount payable into the DROP would be the DC contribution limit ($54,000 per year) in Section 415c of the Internal Revenue Code.

XVII. CONCLUSION

IF YOU HAVE ANY QUESTIONS OR COMMENTS CONCERNING THIS PRESENTATION, CONTACT ROBERT D. KLAUSNER, ESQUIRE, **KLAUSNER, KAUFMAN, JENSEN & LEVINSON, 7080 N. W. 4TH STREET, PLANTATION, FLORIDA 33317, (954) 916-1202, FAX (954) 916-1232, E-MAIL bob@robertdklausner.com.** **Visit our website www.robertdklausner.com.**

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