CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

BOARD OF ADMINISTRATION FIDUCIARY EDUCATION PROGRAM

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I. THE PURPOSE OF THE MATERIALS

The purpose of the following materials is to provide a sampling of legal, financial, ethical, and philosophical material related to the mission of a fiduciary. The idea of a fiduciary being the steward of another's property is centuries old. No one outline could cover the entirety of the volumes of court decisions, scholarly articles, and economic treatises on the subject. It is hoped that the materials here will provoke thought and discussion on an on-going basis for the betterment of CalPERS.

II. 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 consultants.

B. <u>Judicial Standards</u>

1. **<u>Meinhard v. Salmon</u>**, 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. **<u>NLRB v. Amax Coal Co.</u>**, 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.

III. CALIFORNIA'S DEFINITION OF A FIDUCIARY

A. <u>Article XVI, Section 17, California Constitution</u>.

Constitution uses the Prudent Investor standard. See, Cal. Gov. Code 20151.

B. <u>History behind the provision</u>.

Arose after *Claypool v. Wilson*, 6 Cal.Rptr.2d 77 (Cal. App. 3 Dist. 1992) which approved the Governor selecting System actuary and essentially usurping the independence of the state retirement systems and their boards of trustees.

C. Limits of the Provision.

System is not a guarantor of every promise made by an employing agency. *City of Pleasanton v. Board of Administration*, 149 Cal.Rptr.3d 729 (Cal. App. 1 Dist. 2012). There is no duty to pay greater benefits than the statutes allow. *Chaidez v. Board of Administration*, 169 Cal. Rptr.3d 100 (Cal. App. 3 Dist. 2014).

D. Judicial Definition.

Fiduciary duty to the members means to deal fairly and act in good faith. *Hittle v. Santa Barbara County Employees' Retirement Ass'n,* 39 Cal.3d 374 (1985).

E. Where Does the Legal Duty to Act Lie?

1. Trustees have a duty to secure full payment of all contributions owed to the Fund in a timely manner.

2. Trustees have a duty to enforce the provisions of the legislation as written. If legislation proves to be unwise, it is a matter for the Legislature to resolve. California courts have enforced the rights of retirement plans to secure their assets and income streams from interference. *Teachers' Retirement Board v. Genest,* 65 Cal. Rptr.3d 326 (Cal. App. 3 Dist. 2007).

3. Trustees have a duty to adopt sound actuarial and investment policies designed to protect the interests of the members and beneficiaries of the System.

F. 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, Albert's* 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.

IV. RESPONSIBLE INVESTING - DOING WELL BY DOING GOOD

A. 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.

B. 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.

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

D. 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.

E. 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.

F. 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.

G. Directed Investment In Prisons Held Not To 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)

H. **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).

Congress later acted to enable state action in the Sudan Accountability and Divestment Act of 2007.

I. Constructive Engagement.

Many states, as an alternative to divestiture, have adopted laws requiring constructive engagement. 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. Florida has a direct prohibition relating to Cuba in 215.472, which will be directly impacted by recent federal outreach to normalizing relations with Cuba. For example, as an alternative to divestment, which would have substituted the legislature as the fiduciary for the boards of trustees, Louisiana law encourages public retirement systems to engage companies to foster change from within rather than simply withdraw from the marketplace. This shifted the decision making back to the boards of trustees who are tasked with ensuring positive investment performance, based on non-political factors.

J. Divestiture of Fossil Fuels.

1. Generally shunned by pension plans and large endowments as destructive of the mission of achieving the highest and best return at a reasonable risk.

2. Divestiture has most recently been criticized for loss of an investor voice in a critical industry that directly impacts virtually every economic sector in which pension plans are invested.

3. The goals of ESG, particularly in the area of sustainability, are directly compromised by loss of the presence at the corporate table, thereby making divestment of fossil fuels a "futile act," according to Professor Edward Zelinsky of the Cardozo School of Law.

4. The first question to asked in any mission based divestment decision is whether the divestment will advance or damage the long term return of the System or will other enhance or resist risk management in the portfolio. If the increased risk or diminished return is the most likely result, the social issue, no matter how worthy must take a "back seat" to the primary mission of the fiduciary to invest System assets for the highest and best return with a reasonable degree of risk.

K. Department of Labor Issues Advisory Opinion on Political Proxies.

1. The U.S. Department of Labor, which regulates ERISA plans, issued a recent advisory opinion which may have influence on governmental plan efforts to address political issues in proxy matters. Fiduciaries are required to act in the best interest of the members of the retirement plan. This includes the duty to exercise proxy votes on issues that affect the value of plan investments. The DOL stated it is the duty of fiduciaries to weigh the cost of developing proxy resolutions, proxy voting services and the likely effect of such activities on the value of the plan investment.

2. The DOL went on to state that any activities designed to monitor or influence the management of a corporation is consistent with the fiduciary duty under ERISA only to the extent it is expected to enhance the value of the plan investment in an amount over and above the cost of the

activity. The opinion clearly advises fiduciaries against proxy activities that relate to political or social issues unless it can be shown that the activity will also enhance the value of the stock. DOL Advisory Opinion 2007-07A

L. What is the ERISA Standard?

2509.94-1 Interpretive Bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments.

This Interpretive Bulletin sets forth the Department of Labor's interpretation of sections 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA), as applied to employee benefit plan investments in "economically targeted investments" (ETIs), that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan. Sections 403 and 404, in part, require that a fiduciary of a plan act prudently, and to diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. In addition, these sections require that a fiduciary act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to their participants and beneficiaries. The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.

With regard to investing. The regulation provides that the prudence requirements of section plan assets, the Department has issued a regulation, at 29 CFR 2550.404a-1, interpreting the prudence requirements of ERISA as they apply to the investment duties of fiduciaries of employee benefit plans404(a)(1)(B) are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly. This includes giving appropriate consideration to the role that the investment or investment course of action plays (in terms of such factors as diversification, liquidity and risk/return characteristics) with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility.

Other facts and circumstances relevant to an investment or investment course of action would, in the view of the Department,

include consideration of the expected return on alternative investments with similar risks available to the plan. It follows that, because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.

The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements are met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate section 404(a)(1) (A) and (B) and the exclusive purpose requirements of section 403.

[59 FR 32607, June 23, 1994]

V. THE SAN DIEGO EXPERIENCE - A CAUTIONARY TALE - THE ESSENTIAL FACTS[1]

A. The Background

In 1996 and again in 2002, the San Diego Retirement Board of Trustees, the City Council and other senior elected and appointed officials of the city put into place two programs that were designed to alter the formula for funding of the retirement system. The eventual result, following poor market conditions in 1999 and 2002, was an accrued unfunded actuarial liability in excess of $1 billion where previously an actuarial surplus had existed.

The events were driven an agreement to have the employer pay less to address budget shortfalls and in return, the City approved enhanced benefits which combined with the decreased funding ultimately created a financial debacle.

The agreement was contingent on the pension board agreeing to a payment plan in which the city would make annual payments according to a fixed formula of slowly increasing percentages of total payroll instead of the annual contribution calculated each year by the

[1] All facts are taken from Kroll, Inc. Report and have not been independently verified. The full report is available at www.signonsandiego.com

retirement plan actuary. The retirement board was warned by its then outside counsel of potential breaches of fiduciary obligations.

In 2002, it became apparent that the minimum required funded ratio floor would be reached and that a large payment would be required by the city to reach the required funding ratio. City officials began looking for options. A 2002 proposal to further extend the funding obligations ultimately led to an even larger increases in unfunded liability.

This was compounded in January 2003 with the filing of a class action by retired employees concerning the underfunding of the retirement system and seeking to force full funding. By 2004, the funded ratio of the retirement system had dropped to 67.2% and the unfunded accrued actuarial liability had risen above $1.1 billion.

The City commissioned a study performed by Kroll, Inc., a risk management firm, concluded that blame for the pension crisis was fairly spread throughout municipal government. The report concluded that in adopting the alternative funding proposals, the board breached its fiduciary responsibility to the retirement system by acting imprudently and contrary to the interests of the system. The report also criticized the board for ignoring the advice of professional advisors who cautioned against potential legal and actuarial problems. Ultimately, the pension board was criticized for its failure to maintain the financial stability and political independence of the pension system.

The city government itself, including the city council, the mayor, and various appointed financial officials of the city, were criticized for their urging of funding methodologies which were not in the best interest of the retirement system. The city was criticized for its undue reliance upon surplus earnings which were utilized for a variety of funding issues and were seriously impacted by declining market conditions.

City officials were also criticized for their failure to adequately disclose the true financial condition of the city at a time when it was going to the public bond markets to obtain money from investors.

B. <u>The Fallout to the Trustees</u>

Six former members of the board of trustees were charged in criminal actions in both state and federal court. Additionally, the former administrator and in-house counsel were charged in the federal criminal proceedings.

Legal battles also ensued on the civil front with the continuation of the retiree funding suit (which was recently settled) and civil actions filed by the city attorney in an effort to assert control by his office over the legal affairs of the retirement system.

C. **<u>Results of the End Game</u>**

In a closely watched case of particular interest to governmental defined benefit pension boards, the California Supreme Court held that multiple felony conflict of interest indictments against five San Diego pension trustees should have been dismissed. The Court recognized that while it was true that the five trustee defendants were financially interested in the pension amendments they voted on, nevertheless, this was not improper since the identical financial interest was shared with several thousand members of the retirement system. According to the Court, the fact that employee trustees who were elected by the membership are stake holders does not present a voting conflict, but rather is an inevitable result of the intentional composition of many retirement boards.

Accordingly, trustees are properly entitled to vote on matters in which they share a generalized financial interest in common with the membership. Otherwise described by the Court, the public services exception to Section 1090 applies if the interest in question "is not personal to an employee or official because it is shared with like members of the public agency's constituency." Ordinary pension board decisions which commonly affect the financial interests of employees do not present the kind of systemic danger that California's conflict of interest laws were designed to criminalize.

The Court concluded that when voting on amendments applicable to the membership as a whole, trustees are covered by the public services exception since they are not ordinarily burdened by a prohibited conflict between their duties as public servants and their own personal financial gain. The public services exception, Section 1091.5(a)(3), recognizes that financial interests shared with one's constituency do not present the dangers the state's conflict of interest laws were designed to prevent as long as there is no "differentiation between their financial interests and the financial interests of those they represent." In so holding, the Court rejected the argument that trustees were required to follow an antiseptic, disinterested model of decision making.

In interpreting the statutes, the Court harmonized Section 1090 and the applicable pension provisions mandating employee participation

on retirement boards. In examining the nature and composition of public pension boards, the Court was mindful that the Legislature has long embraced the principle of employee representation. According to the Court, it is "quite clear the Legislature *intended* for retirement board trustees to share interests with their memberships." The Court further recognized that having trustees who share the interests of their constituents was beneficial. The Court further reasoned that by mandating employee representation on retirement boards, the Legislature did not intend that these same employee trustees would be second class citizens on their boards, prevented from participating on important votes.

The Supreme Court's interpretation of the conflict of interest laws and who is or is not permissible is best summarized as the following rule:

> If the financial interest arises in the context of the affected official's or employee's role as a constituent of his or her public agency and recipient of its services, there is no conflict so long as the services are broadly available to all others similarly situated, rather than narrowly tailored to specially favor any official or group of officials, and are provided on substantially the same terms as for any other constituent.

Lexin v. The Superior Court of San Diego County, 47 Cal. 4th 1050, 222 P.3d 214 (2010).

D. Lessons Learned

A number of basic lessons can be learned from the San Diego experience.

1. Violating basic principles of fiduciary responsibility leads to potentially disastrous results.

A fiduciary is defined as a person who exercises discretionary authority over a retirement plan and its assets. That person is expected to act exclusively in the best interests of the system and its members. Fiduciary responsibility extends to both investment management and benefit administration.

2. There is no such thing as a free benefit.

Ultimately, the San Diego pension crisis was created largely due to inadequate funding. While funding of retirement benefits through the use of actuarial gain is not, in and of

itself, illegal or imprudent, it carries with it the risk of utilizing the "actuarial cushion" created in good investment years that will ultimately protect the plan, the beneficiaries and the plan sponsor in unfavorable years. There are means to avoid this problem. For example, Anchorage, Alaska utilized surplus assets of its retirement system to create excess benefits for members but required a specific actuarial cushion be maintained and further required that $.25 of every dollar of surplus assets actually employed be further added to the actuarial cushion. If both actuarial cushions were utilized, employer and employee contributions would be required to fill any such loss.

3. Benefits must be funded on a sound actuarial basis.

The use of actuarial methodology to reduce funding, particularly when coupled with promised benefit increases, is an appealing alternative. It may not, however, be an actuarially sound one. Actuarial methodologies must be intellectually honest and strictly adhered to.

The use and misuse of actuarial standards and funding methodologies have been widely experienced. The results in the courts have been as diverse as the factual situations that gave rise to the disputes. The following summaries are judicial decisions discuss when boards of trustees successfully challenged asset misdirection and legislative incursion into actuarial practices and protected their systems and participants:

Louisiana Municipal Association v. State, 893 So2d. 809 (La.2005)

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. The court held that employers participating in defined benefit retirement systems could not avoid their constitutional duty to fund the retirement systems according to their actuarial need. Even if the cost was a

burden on the employer, the solution was in the legislature, not the courthouse.

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.

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 was found by the Court even though no pension payments were missed. Unilateral reduction in the 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.

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.

Wisconsin Retired Teachers v. Employee Trust Funds, 558 N.W.2d1983 (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 disallowed the use of 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.

Courts have not, however, been consistent in enforcing the fiduciary mandate as evidenced by the following cases in what are not surprisingly some of the nation's worst funded plans:

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

The Legislature amended a 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. The statute stated that pension is an "inviolable contract" not subject to reduction or impairment. The retirement board challenged the change in its powers. The Kentucky Supreme Court held that the 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. The Court upheld the

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.

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.

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

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.

The perilous condition of the state systems has again given rise to a claim that funding changes are imminently required to avoid insolvency. In 2013, the Legislature passed substantial reductions in benefits for future and current participants, but in return, waived immunity from suit which had been the basis of its successful defense in 1997. The State is contending that the enhanced and enforceable promise to pay is an offsetting improvement justifying the reductions. The reductions have been held unconstitutional by a state trial court and the fate of the statute and the reform program rests with the Illinois Supreme Court.

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

A teachers' union filed a lawsuit against the state due to the state's failure to make contributions 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 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. The Following year, the New Jersey Legislature adopted Chapter 78, Laws of 2011, in which the State waived its immunity on funding challenges as part of an agreement to suspend COLA payment, increase contributions for employees, and set up a 7 year enhanced contribution program by the State. In 2014, the State declined to pay citing fiscal shortfalls and

again refused to pay in the 2014-2015 fiscal year. Suits by the participants and the Boards of Trustees are pending.

4. **Independence is critical**.

The independence of the board of trustees is a critical element to the successful exercise of fiduciary responsibility. Independence does not just mean independent from the plan sponsor. The board of trustees, in the exercise of its responsibilities must be independent from any outside influences. Whether one is appointed to the board of trustees by the plan sponsor, elected by the employees (including retirees) or serves by virtue of another office, while sitting on the retirement board the exclusive duty must be to the plan and its participants. Ironically, at least one state, Minnesota, places a fiduciary responsibility on trustees to the plan and its participants, to the plan sponsor and to the taxpayers. Clearly such a divided sense of duty is a virtual impossibility but nonetheless the statute remains in force.

The primary criticism regarding independence in San Diego is that the trustees failed to separate their desire to improve benefits or to ameliorate the city's cost from the need to ensure proper funding of the retirement system.

5. **Sometimes the answer is no**.

The lesson of independence also relates to providers of services to retirement plans as well. Particularly, actuaries and lawyers must be free to give their advice without regard to its political consequences. It is the duty of any fiduciary to the retirement system to say "no" when any answer to the contrary is not in the best interest of the system.

6. **Avoiding self-interest.**

One of the issues in the criminal prosecutions of the trustees, administrator and former in-house counsel is that all of them benefitted from the changes made in the retirement system.

The Kroll report criticized the plan actuary and the fiduciary counsel in place at the time the second Manager's Proposal was adopted for failing to act as an adequate gatekeeper on changes to the funding methodology.

7. **It is not necessarily about bad motives.**

With a few notable exceptions, the Kroll report found that the participants on whom blame was placed for the failures in San Diego were not motivated by personal gain. The report is an indictment for the failure to distinguish between conflicting interests and in resolving fiduciary decision-making contrary to the best financial interests of the retirement plan.

In the final analysis, the case was about not paying the bill on time.

VI. WHAT DO SUITS AGAINST FIDUCIARIES LOOK LIKE?

A. Fallout from Unfavorable Investment Performance.

The common result of an unfavorable investment result over the last 10 years has been a proliferation of suits by plan participants against the trustees. The following are some notable examples:

1. **Suit against state retirement plan barred by 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)

2. **Case against teachers retirement system dismissed based on lack of injury.**

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)

3. **New Mexico retirees cannot sue for investment losses to system.**

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, 834 F.Supp2d 1228 (D.N.M 2011)

4. **Michigan class action for breach of fiduciary duty relating to investments results in an adverse finding.**

In September of 2009, the trial court certified a class action consisting of participants and beneficiaries of the Detroit Plan who were seeking to recover millions of dollars resulting from investments which "in hindsight should not have been made" (quoting from the Defendants' brief). Eight cases were consolidated for appeal.

The Appeals Court issued a lengthy opinion dismissing some claims on the basis of discretionary immunity. The Michigan Court of Appeals also held that the participants had standing to pursue their state law claims under the public pension investment fiduciary law against the investment advisor defendants. The members were also held to have standing to assert their (I) common-law and statutory conversion claims; (ii) causes of action grounded in the trustee defendants' "extravagant, unnecessary and improper trips", and (iii) I claims against trustee defendants and investment advisor defendants for violation of Art 9, Section 24 of the Michigan Constitution which protects "accrued financial benefits."

Estes v. Adrian Anderson (unpublished) 2012 WL 5857283

Statute widening discretionary authority of board in actuarial matters does not impair member rights.

A retired state employee sued the Public Employees' Retirement System arguing that a statute which changed the method by which the board calculated certain retirement benefits and which resulted in a lower monthly

benefit to the employee was an unconstitutional delegation of legislative power to an administrative agency. The Montana Constitution expressly protects public employee retirement benefits. It also authorizes the board of trustees to set actuarial standards for the system. Following the adoption of that constitutional provision, the Legislature passed a law at the request of the retirement system empowering it to set “actuarial equivalents” for certain survivorship benefits. The board adopted a more modern mortality table which resulted in an increase in the actuarial reduction applied to certain survivorship benefits. This meant that an employee selecting a survivorship benefit would receive a lower lifetime annuity. The employee sued claiming that the board unconstitutionally impaired his retirement benefits and exercised a legislative power by adopting a different mortality table. The Montana Supreme Court rejected the argument finding that the people of Montana expressly authorized the board of trustees as a fiduciary to set actuarial standards for the system and its action was therefore not an unlawful delegation of power.

Baumgardner v. PERB, 119 P.3d 77 (Mont. 2005).

B. The Boards are not Alone.

Numerous actions have resulted in major decisions involving suits by both systems against professional advisors and most recently by participants against professional advisors.

1. Retirement system was not contributorily negligent and thus actuary was liable for $72,000,000 in lost contributions and lost interest.

Milliman was hired in 1982 to provide actuarial valuations for each of Maryland’s state systems. In 2004, Milliman discovered a longstanding coding error during a replication audit. Milliman’s calculations treated code “00” as meaning only a straight life annuity, even though code “00” also included 50% survivor spouse benefits. The State Board of Contract Appeals determined that Milliman had breached its contract to provide actuarial services. The System was awarded $34 million in lost contributions and

$38 million in lost interest on those contributions. Milliman appealed arguing that the System was not damaged insofar as the taxpayers would fund any deficiency. Milliman also argued that the System was not harmed because notwithstanding the 22 years of actuarial errors, ultimately the System would become fully funded. The lower court determined that this perspective "subverts the entire function and purpose of actuarial analysis, which is to determine how much to contribute and when." If Milliman's arguments were accepted, it could satisfy its contractual obligations by training a monkey to punch random keys on a calculator. The Maryland Court of Appeals, the highest court in the state, agreed. It rejected Milliman's argument that the state retained the use of the contributions, which were not deposited into the System. The Court refused to recognize an offset, finding that the state and System are distinct entities.

According to the Court, to the extent that the data coding may have been confusing, the actuary bore an express duty to solicit further clarifying information until it accurately understood the information provided by the system. The court credited the testimony of a third-party actuarial expert, witnesses, and trustees that the System had suffered losses and was underfunded as a result of the errors.

On the voluminous records, the court held that substantial evidence supported the lower court's findings that Milliman repeatedly misinterpreted a data code associated with survivors' benefits. The System was not negligent in the development or transmission of the data. As a result, Milliman was fully liable and contributory negligence was not a bar to recovery.

Milliman, Inc. v. Maryland State Retirement and Pension System, 25 A.3d 988 (Md. 2011)

2. Member suit against actuaries reinstated.

In November, 2014, a California appeal court reinstated a member suit against a retirement system actuarial firm

and the individual actuary, even though the claims against the System were dismissed. Beneficiaries of the Stanislaus County retirement system sued the System for accepting erroneous actuarial assumptions which lead to the underfunding of the plan. The members also sued the actuarial firm. The claim against the Board related to its determination not to sue the actuaries. The Court of Appeals upheld a dismissal of the claim against the System on the basis of discretionary governmental immunity. It reinstated the claim against the actuaries for allegedly aiding and abetting a breach of fiduciary duty by encouraging the trustees to make improper actuarial and funding determinations.

Nasrawi v. Buck Consultants, *LLC,* 231 Cal. App.4th 328 (6th Dist. 2014).

VII. WHAT HAVE WE LEARNED?

A. In large measure fiduciary duty is common sense about right and wrong. If an issue gives one pause for thought that it might be wrong, it probably is.

B. The primary duty of a pension fiduciary is to act in the best interests of members and beneficiaries of the System. Only if that result abides, do additional concerns enter the decision process.

C. Liability is largely the product of poor planning and a failure to recognize its consequences.

D. Pension trustees have 2 jobs - (1) set policy and (2) demand accountability that the policy is being properly executed.

E. Understand the subject matter. Ask questions until one gets an answer.

F. Delegation to staff and professionals IS the exercise of fiduciary duty if there is continuing accountability.

G. Micro management and policy making are poor partners.