

STAFF'S ARGUMENT TO ADOPT IN PART THE PROPOSED DECISION

I

THE BOARD'S REQUEST FOR A FULL BOARD HEARING

At its September 17, 2015 meeting, the Board of Administration (Board) requested a Full Board Hearing in connection with the appeal of Respondent Bruce Malkenhorst, a felon convicted of misappropriating public funds. After a six-day administrative hearing, the Administrative Law Judge (ALJ) issued a Proposed Decision, correctly finding that Malkenhorst had been receiving a retirement benefit inflated by an improper payrate. The improper payrate was the result of Malkenhorst's "obfuscation" and subversion of the transparency requirements of the PERL, and was properly reduced by CalPERS.

The Proposed Decision did, however, contain two errors. First, it improperly rejected CalPERS' reanalysis of Malkenhorst's payrate. Second, it rejected substantial evidence that Malkenhorst's payrate included overtime pay.

The Proposed Decision also failed to address an important issue: recoupment. Malkenhorst has argued that CalPERS is time-barred from recouping the overpayment of retirement benefits to Malkenhorst. CalPERS has argued for its right to recoup the overpayments, which total \$3,486,190.74.

By ordering a Full Board Hearing, the Board may consider the issue of recoupment and will determine whether the Proposed Decision is supported by the law and consistent with the facts presented over the six-day administrative hearing.

II

SUMMARY OF THE CASE

Malkenhorst was employed by the City of Vernon from 1977 to June 30, 2005, and during most of that time, he served as Vernon's full-time City Administrator/City Clerk. After his retirement, in 2011, Malkenhorst was convicted of felony misappropriation of public funds. (Proposed Decision, p. 3, ¶ 5.)

At the time of Malkenhorst's retirement, the City Administrator/City Clerk position was listed on a pay schedule with a monthly base salary of \$35,302. (Malkenhorst also received 25% longevity pay as an item of special compensation.) For purposes of his retirement benefit, Malkenhorst was initially credited with a payrate of \$35,302.

The legitimacy of Malkenhorst's payrate was called into question during an audit of the City that began in 2011. The audit revealed that Malkenhorst was not only being paid to serve as full-time City Administrator/City Clerk, but he was also receiving compensation to serve as Treasurer, CEO of the City's power department, and several other positions not listed on the City's pay schedules. Based on available City records, CalPERS reduced Malkenhorst's payrate to \$7,875 and his longevity pay from 25% to 20%. Malkenhorst appealed, and an evidentiary hearing before the ALJ was held over six

days: August 25-27, 2014; September 3-4, 2014; and February 19, 2015. The ALJ issued a Proposed Decision on July 14, 2015.

The Proposed Decision **affirmed** CalPERS' decision to reduce Malkenhorst's payrate. The City and Malkenhorst were improperly using the position of City Administrator/City Clerk "as a catch-all payrate category," (Proposed Decision, p. 10, ¶ 30), which "concealed from public view" (Proposed Decision, p. 21, ¶ 25) the connection between Malkenhorst taking on new positions and receiving payrate increases. The ALJ also reduced Malkenhorst's special compensation, from 25% of his base salary to 20%.

In two respects, the Proposed Decision was at odds with the positions taken by CalPERS. First, the ALJ stated his belief that CalPERS acted arbitrarily in selecting \$7,875 for Malkenhorst's payrate. The ALJ did not, however, identify a more appropriate payrate or explain how one might be determined. Second, the ALJ ruled that CalPERS lacked sufficient evidence to conclude that Malkenhorst had been receiving undeclared overtime pay.

The Proposed Decision came before the Board at its meeting on September 17, 2015, with a staff argument to decline the Proposed Decision and conduct a Full Board Hearing. Malkenhorst submitted his written argument that the Board should reject the Proposed Decision in part and adopt it in part. The Board declined to adopt the Proposed Decision and voted to conduct a Full Board Hearing.

III ISSUES PRESENTED

- A. Did CalPERS act within its discretion in selecting \$7,875 as Malkenhorst's payrate?
- B. Did CalPERS reasonably infer that Malkenhorst was being paid for working overtime (i.e., more than 40-hour weeks)?
- C. May CalPERS recoup from Malkenhorst historical overpayments of retirement benefits?

IV FACTUAL BACKGROUND

Malkenhorst began working for the City in 1977, and in 1978, became the Treasurer and City Administrator/City Clerk. As the years went on, Malkenhorst took on several other positions at the City. (CalPERS Exhibit 85.) Significantly, in May 1981, Malkenhorst became the Chief Executive Officer of the Electrical Department (later named the Light and Power Department), a position created to address the Department's "increased work load in administration and operation." (CalPERS Exhibit 14, first recital; CalPERS Exhibit 16.) Malkenhorst was subsequently appointed Executive Director and Secretary of the Redevelopment Agency (CalPERS Exhibit 31,

p. 2), CEO in the Gas Municipal Utility Department (CalPERS Exhibit 37, p.30), Executive Director, Secretary and Treasurer of the Industrial Development Authority (CalPERS Exhibit 32, p. 2), and Executive Director of the Vernon Historic Preservation Society. (CalPERS Exhibit 64.)

City Administrator/City Clerk was a full-time, 40-hour position listed on a publicly available pay schedule. (CalPERS Exhibit 11, p. 12; CalPERS Exhibit 12, p. 2.) Malkenhorst's other City positions were unlisted, but he was nonetheless receiving compensation for them. For example, when Malkenhorst became the CEO of the L&P Department in May 1981, he did not receive an immediate salary increase. But in July 1981, when the next City budget was approved, Malkenhorst received the first of several raises. Those raises totaled 24% in a period during which the Consumer Price Index rose just 7%. (CalPERS Exhibit 85; Proposed Decision, p. 5, fn. 7.)

The City made it clear that Malkenhorst's sizable salary increase was related to his new Light and Power duties: "The City Administrator/City Clerk shall serve as the Chief Executive Officer in the Light and Power Department and **the compensation for said position is included** in the compensation established for the position of City/Administrator/City Clerk..." (CalPERS Exhibit 16, p. 20, emphasis added; CalPERS Exhibit 65, p. 35.) Similarly, when Malkenhorst was appointed CEO in the Gas Municipal Utility Department, the City declared that his pay for the position would be included within his City Administrator/City Clerk salary. (CalPERS Exhibit 37, p. 30.)

By the end of his tenure, Malkenhorst was still ostensibly employed full-time as City Administrator/City Clerk, but on a percentage basis, most of his time was spent in other pursuits. Thus, for the 2003 budget year, Malkenhorst's salary was apportioned across City departments as follows: 20% to City Administration [Dept. 1002], 5% to City Clerk [Dept. 1003], 15% to Finance [Dept. 1004], 5% to Treasurer [Dept. 1015], 5% to Personnel [Dept. 1018], 20% to Redevelopment [Dept. 1022], 10% to Gas [Dept. 5600], and 20% to L&P Administration [Dept. 9000]. (CalPERS Exhibits 67 and 81.) For the 2004 budget year, Malkenhorst's last year with the City, the allocation of Malkenhorst's salary to the City Administration and City Clerk departments dropped to only 10%, while the allocation to the L&P Department increased from 20% to 65%. (CalPERS Exhibit 68, p. 3; CalPERS Exhibit 81.) Yet Malkenhorst was still reporting a monthly payrate of \$35,302 for working 40-hour weeks entirely as City Administrator/City Clerk, together with a 25% longevity bonus. (CalPERS Exhibit 65, p. 20.)

Because City Administrator/City Clerk was a full-time, 40-hour position, CalPERS concluded that Malkenhorst must be working overtime (i.e., in excess of the City's standard 40-hour week) to complete the duties of his other positions. CalPERS first raised this concern in 1995 in two letters sent to Gloria Orosco, Malkenhorst's personal secretary. CalPERS stated that Malkenhorst's positions apart from City Administrator/City Clerk "would be considered overtime," so the City needed to "make notation for the percentage of [Malkenhorst's] time that was spent in each position." (CalPERS Exhibits 47 and 48.) Both letters were ignored.

From his retirement in July 2005 until April 2014, Malkenhorst was credited with the payrate (\$35,302) and special compensation (25% longevity pay) that had been reported to CalPERS by the City. The validity of those reported numbers, however, came into question during a 2011 audit of the City. During the audit, the City confirmed Malkenhorst's work in multiple positions, but the City could not produce records showing the hours Malkenhorst spent in those positions or publicly available pay schedules for positions other than City Administrator/City Clerk. Without this information, CalPERS could not perform a mathematical calculation of Malkenhorst's payrate.

In furtherance of its obligation to redetermine Malkenhorst's payrate, CalPERS looked to the publicly available pay schedule the City put into effect immediately upon Malkenhorst's retirement. That pay schedule suggested that the City Administrator/City Clerk position had been split into three new, full-time positions: Acting City Clerk (\$7,875 per month), Acting City Treasurer (\$7,875 per month), and Acting Director L&P (\$24,000 per month). (CalPERS Exhibit 75, pp. 11 and 22.) CalPERS selected for Malkenhorst's payrate the \$7,875 salary for Acting City Clerk because that position most closely resembled the former City Administrator/City Clerk position the City had disclosed to the public on pay schedules.

CalPERS also reexamined Malkenhorst's special compensation. CalPERS noted that Malkenhorst was the only City employee entitled to a 25% longevity bonus for his length of tenure; other department heads could receive only a 20% longevity bonus for having worked the same number of years. (CalPERS Exhibit 65, p. 20.) CalPERS therefore determined that the 20% bonus would also constitute Malkenhorst's special compensation.

V ARGUMENT

A. The Proposed Decision Should Be Adopted in Part

The central issue on Appeal has been whether CalPERS must use Malkenhorst's City Administrator/City Clerk base salary as his payrate. CalPERS and the ALJ agree: the answer is "no" because a member's payrate cannot include compensation for positions not disclosed in publicly available pay schedules. (See, Section 20636(b)(1) and Cal. Code Regs., tit. 2, § 570.5(a)(2) and (a)(3).) Here, Malkenhorst received a salary for working full-time as City Administrator/City Clerk, but that salary included compensation for working in several other City positions that were not separately described on City pay schedules. The ALJ described this practice as obfuscation:

For most of the positions assigned to respondent Malkenhorst, there was no publicly available pay schedule and there was no public accountability for payrates associated with newly-created positions. Vernon and respondent Malkenhorst obscured any connection between respondent Malkenhorst's pay increases and the positions and duties he was assigned, making it impossible for any member of the public to ascertain

how much the city was paying for services associated with numerous important city functions.... All of this obfuscation and blurring of the line between job title and payrate subverted the transparency requirements of the PERL. (Proposed Decision, p. 8, ¶ 22.)

The ALJ's payrate analysis is absolutely correct and should be adopted by the Board. The Board should also adopt the ALJ's ruling that CalPERS properly reduced Malkenhorst's longevity pay (as an item of special compensation) from 25% to 20%. The reduction in special compensation was proper because Malkenhorst could not receive special compensation beyond that available to "similarly situated members of a group or class of employment." (Gov. Code, § 20636(c).)

B. The Proposed Decision Should Be Rejected in Part

1. The Proposed Decision impermissibly limits the Board's discretion to determine payrate.

Because the City and Malkenhorst were improperly using the position of City Administrator/City Clerk "as a catch-all payrate category" (Proposed Decision, p. 10, ¶ 30), the City's pay schedules could not be used to determine Malkenhorst's payrate. When such situations arise, "the Board, in its sole discretion, may determine an amount that will be considered to be payrate, taking into consideration all information it deems relevant..." (Cal. Code Regs., tit. 2, §570.5(b).)

CalPERS reasonably exercised its discretion here, selecting a payrate for Malkenhorst of \$7,875 – the full-time monthly pay for the positions of Acting City Clerk and Acting City Treasurer created upon Malkenhorst's departure. The ALJ ruled, however, that the selection of this payrate was arbitrary because certain relevant information had not been considered, specifically the payrate for "Malkenhorst's successor as City Administrator." (Proposed Decision, p. 11, ¶ 34.) The ALJ apparently did not realize that the City did not name a City Administrator to take over for Malkenhorst. (CalPERS Exhibit 75, pp. 21-22 [showing that the City Administrator position was eliminated from the City's pay schedules following Malkenhorst's departure.]) The City finally hired a full-time administrator some four years after Malkenhorst's retirement (at a monthly payrate of \$32,000), but there is no evidence that the new position is comparable to the old administrative position previously held by Malkenhorst, either in responsibilities or hours.

When the Board acts in its discretionary function to set a payrate, there are no clear standards for what may be considered arbitrary and what may be considered reasonable. The Proposed Decision overlooks this problem and, without guidance or analysis, suggests that CalPERS might be able to identify a better payrate for Malkenhorst. (Proposed Decision, p. 11, ¶ 34.) The ALJ's subjective belief that a better payrate may be found for Malkenhorst does not mean that CalPERS' prior decision-making process was somehow arbitrary. In fact, CalPERS' determination was demonstrably rooted in its analysis of the City's records and should be affirmed.

2. The Proposed Decision permits managerial employees to avoid the PERL's requirement that overtime pay be excluded from payrate.

The lack of reliable City pay schedules is not the only ground for reducing Malkenhorst's payrate. A second reason is the overtime pay received by Malkenhorst and incorporated into his salary as City Administrator/City Clerk.

There is no dispute that payrate cannot include compensation for working "in excess of the hours of work considered normal for employees." (Gov. Code, § 20635; Section 20636(b)(1).) But Malkenhorst has argued that this overtime rule does not pertain to him because he is an "FLSA-exempt" managerial employee. Not so. There is no direct conflict between the Fair Labor Standards Act and the PERL, and in any event, "PERS is free to define 'overtime' in a manner distinct from federal law." (*City of Sacramento v. Public Employees Retirement System* (1991) 229 Cal.App.3d 1470, 1485-86.)

Under the PERL's overtime rules, neither the City's high-ranking managers nor its rank-and-file employees are able to include in their pension calculations the compensation received for working beyond the City's standard 40-hour week. (See *Matter of Ramirez*, Precedential Decision 00-06, affirming CalPERS' determination that a full-time police chief received overtime pay to act as city manager.) The two groups differ, however, in their ability to conceal overtime pay. Overtime pay to rank and file employees is transparent because it is routinely segregated in the payroll reports the agencies submit to CalPERS. The same is not true for managerial employees, for whom regular and overtime pay – for one position or multiple positions – may be lumped together in a single salary.

To disentangle a managerial employee's regular pay and overtime pay, CalPERS has only one tool at its disposal: it can require agencies to keep and produce information on their employees' positions, hours, and pay increases. (Gov. Code, § 20221(b).) This was CalPERS' approach with Malkenhorst. Malkenhorst was purportedly a full-time, 40-hour-a-week City Administrator/City Clerk, but in 1995, CalPERS noted that he was also working in several other City positions. CalPERS therefore concluded that Malkenhorst must be working overtime, and to make sure, twice requested that he "make notation for the percentage of time that was spent in each position." (CalPERS Exhibits 47 and 48.) As chief administrative officer of a contracting agency, Malkenhorst was obliged by statute to provide the information CalPERS requested (Gov. Code, § 20221(b)), but he didn't.

The Proposed Decision found that Malkenhorst was receiving compensation for working in multiple positions, but that there was no direct evidence that Malkenhorst actually worked overtime hours. The ALJ accepted Malkenhorst's testimony that he was able to complete his duties in just 40 to 45 hours each week by delegating as needed to other City employees. (Proposed Decision at p. 7, ¶¶ 17-20.) The ALJ's ruling elevates oral testimony over the primacy of agency records. CalPERS, on the other hand, tethered its evaluation of Malkenhorst's overtime to the City's records because a public records-

based decision serves the goal of transparency. Oral statements, on the other hand, whether provided as part of or before litigation, are less reliable than contemporaneously prepared records, particularly where, as here, the person making the statement is a felon. After-the-fact oral statements are also contrary to the PERL's goal of transparency and are not available to CalPERS in its routine determination of payrate. CalPERS' determination that Malkenhorst worked overtime was reasonable, is supported by City records, and should be affirmed.

3. CalPERS should be permitted to recoup the overpayments made to Malkenhorst

Once the Board affirms Malkenhorst's payrate and special compensation, CalPERS will be able to determine, mathematically, the sum of benefit overpayments to Malkenhorst. CalPERS may then take steps to recoup those overpayments, subject only to Malkenhorst's argument that the recoupment may be time-barred by applicable statutes of limitation. The ALJ declined to address Malkenhorst's time-bar argument, even though it was largely briefed by the parties.

For purposes of efficiency, the Board should exercise its statutory authority to render a "conclusive and binding" decision on the applicability of statutory limitations periods. (Gov. Code, § 20164(e) ["The board shall determine the applicability of the period of limitations in any case, and its determination with respect to the running of any period of limitation shall be conclusive and binding for purposes of correcting the error or omission.]) The PERL has three-year and ten-year limitation of action statutes. (Gov. Code, § 20164(b), (d).) The three-year limitation period applies to any action based on, "an erroneous payment to a member" (Gov. Code, § 20164(b)) unless the erroneous payment was "made as a result of fraudulent reports for compensation," in which case the limitation period is ten years. (Gov. Code, § 20164(d).)

The Board should conclude here that the ten-year limitations period would apply to a civil recoupment action against Malkenhorst. As the ALJ specifically found, CalPERS overpaid retirement benefits to Malkenhorst because he and the City submitted deceptive and misleading reports of his payrate. The payrate reported for Malkenhorst amounted to "obfuscation" because it "obscured" the fact that he was receiving pay for unlisted positions. (Proposed Decision, p. 8, ¶ 22.) Moreover, the City and Malkenhorst, "cooperat[ed] in obscuring what exactly he was being compensated for...." (Proposed Decision, p. 11, ¶ 33.) Fraudulent reporting can also be inferred from Malkenhorst's refusal to address CalPERS' lawful requests that he track the time spent in his various positions. (CalPERS Exhibits 47 and 48.)

In addition, the Board should rule that the statute of limitations period does not begin to run, or "accrue," until CalPERS discovers its overpayment, and that the period is suspended, or "tolled," during the time the alleged overpayment is being litigated. Accrual refers to the date on which a claim is deemed "complete" and the limitations period is triggered. (*Cansino v. Bank of America* (2014) 224 Cal.App.4th 1462, 1472.) Under the PERL, the three and ten year limitation periods presumptively accrue from


the date of any overpayment. (Gov. Code, § 20164(b)(1).) However, "accrual is postponed until a plaintiff discovers, or has reason to discover, the cause of action." (*Cansino*, 224 Cal.App.4th at p. 1472.) Tolling, "a centuries-old concept," refers to the suspension or extension of a statute of limitations for purposes of fairness. (*Los Angeles v. County of Kern* (2014) 59 Cal.4th 618, 624-625.)

Here, the Board should declare that the PERL's limitations periods are subject to the discovery rule and did not accrue, with respect to any payment of retirement benefits to Malkenhorst, until April 27, 2012. That is the date of CalPERS' written report of its City audit, which describes the factual basis of its determination that Malkenhorst's payrate was overstated. (CalPERS Exhibit 86, pp. 12-13.) Moreover, the Board should declare that the limitations periods described in Gov. Code, § 20164 are tolled for the entire period of time in which the allegedly erroneous overpayment has been or will be the subject of an administrative proceeding or civil action. Here, the tolling would begin from the date Malkenhorst gave notice of his administrative appeal (December 21, 2012) and continue until such date that final judgment is entered by this Board or a civil court of competent jurisdiction. Should the Board adopt these accrual and tolling rules, CalPERS would be permitted to recoup overpayments to Malkenhorst totaling \$3,486,190.74.

VI CONCLUSION

The Proposed Decision recognizes that Malkenhorst engaged in obfuscation that resulted in his receipt of a grossly inflated retirement benefit. That said, the Proposed Decision fails to provide CalPERS with a sufficient method to determine a new payrate for Malkenhorst that takes his conduct into account. Accordingly, as specified above, the Proposed Decision should be adopted in part and rejected in part. The Board should affirm a \$7,875 payrate for Malkenhorst, increased by 20% longevity pay as an item of special compensation, and permit CalPERS to recoup past overpayments to Malkenhorst.

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