CalPERS

# Memorandum

California Public Employees' Retirement System

Date: November 12, 2008

To: MEMBERS
BOARD OF ADMINISTRATION

From: Peter H. Mixon
General Counsel

Subject: Responsible Contractor Policy Workshop

Legal Opinions

The Board of Administration will convene a Responsible Contractor Policy workshop on November 18, 2008. Several outside counsel will participate in the workshop. Two law firms were retained to address labor law issues implicated by the Responsible Contractor Policy (RCP). Attached are copies of the opinions written by these two firms: Altshuler Berzon LLP (Altshuler) and Steptoe & Johnson LLP (Steptoe). Both firms were asked to address the legal effects of potential changes to the RCP. In addition, the Board's fiduciary counsel has submitted an opinion explaining the fundamental duties of prudence and loyalty, which apply to investment policies and decisions of the Board. This opinion is also attached.

These legal opinions are provided to facilitate discussion over potential changes to the RCP and to inform board members, staff, workshop panelists, and CalPERS constituents of the legal issues that could arise. To facilitate the discussion at the workshop, these opinions are not confidential and are being provided to all workshop participants. Counsel from each of these firms will also be present at the workshop.

The following is a brief summary of the written opinions of the firms.

## I. Current Policy Application

The RCP states that CalPERS "supports a position of neutrality in the event that there is a legitimate attempt by a labor organization to organize workers employed in the construction, maintenance, operation, and services at a System owned property." Both firms agree that the "neutrality" position applies to the advisors of CalPERS, the partners of CalPERS, and to joint ventures and partnerships in which CalPERS has more than a 50% ownership interest in their capacity as employers. The Altshuler firm further

opines that the current policy also applies to the partners' contractors and sub-contractors. As both firms note, the RCP further provides that when it is inapplicable, CalPERS partners and advisors shall be encouraged to make a "good faith effort" to comply with the spirit of the policy, consistent with their fiduciary duty.

Employers are free to enter into enforceable agreements to remain neutral in relation to a union's efforts to organize their workforce. The RCP states that CalPERS supports a position of "neutrality" but it does not expressly define the term. As both firms note, employer neutrality can take myriad forms. Often the extent of an employer's neutrality is governed by a "labor peace agreement." These agreements can be simple or complex. They may include the following types of provisions:

- The employer's agreement to remain silent on the union's organizational efforts;
- The employer's agreement to provide union access to employees on certain conditions;
- The union's agreement not to engage in strikes or boycotts;
- The employer's agreement to a "card check" voting process;[1] and
- An expedited dispute resolution process (such as binding arbitration).

Typically, these agreements are tailored to local conditions and are expressly enforceable through a contractual agreement.[2]

II. Modification of Neutrality and Remedies Provisions

The RCP is enforced through partnership and other agreements with CalPERS real estate managers. The effectiveness of any material changes to the RCP will be governed, in part, by contract and labor law. We understand that constituent groups have suggested that the Board may wish to make changes in the "neutrality" definition by providing more specificity. In addition, the Board may wish to consider providing for additional remedies on the part of CalPERS for RCP violations. These remedies could include a more robust monitoring role, a ban on further commitments or funds, and partnership termination.[3] Both firms address these provisional changes.

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[1] A "card check" is a form of voting which allows the union to submit union authorization card as evidence of the workers' desire to have the union represent them in collective bargaining. If 30% of the affected workforce signs these cards, then the union can petition to have a secret ballot election. If over 50% sign the cards, then the union can ask that the employer recognize the union without the necessity of an election. See Steptoe opinion at p. 10.

[2] See Altshuler opinion at pp. 4-5; Steptoe opinion at pp. 9-10.

[3] See Altshuler opinion at pp. 2-3; Steptoe opinion at p. 3.

A. National Labor Relations Act Preemption

The National Labor Relations Act (NLRA) generally governs labor relations between private employers and unions. Thus, both firms agree that CalPERS, as a governmental agency, is exempt from the NLRA. This federal law also supercedes, or "preempts," state laws that interfere with its operation. As both firms state, the preemption doctrine precludes state and local governments from regulating activity that the NLRA protects, prohibits, or leaves to the free play of market forces. If a court viewed the RCP as a means of "regulating" this activity or conduct, then it would be "preempted" by the federal labor law and therefore would be unenforceable.

Both firms agree that it is likely the RCP escapes preemption so long as CalPERS acts as a "market participant." Under this exception, when a state entity acts as a market participant in furtherance of proprietary objectives and with no interest in setting policy, its actions are not preempted. Provided that CalPERS does not act in a regulatory capacity, the RCP should be exempt from preemption.[4] In its opinion, the Altshuler firm notes some limitations on this exemption:

- The RCP should serve proprietary objectives, such as minimizing union organizational disputes to avoid risks to investment returns;
- The RCP should not provide exemptions that allow employer advocacy on behalf of unions (non-neutral conduct);
- The RCP should only apply to properties in which CalPERS has an ownership interest; and
- Remedies for RCP violations should follow the proprietary interests of CalPERS.[5]

B. Prospective Enforcement of Changes To RCP Neutrality Provisions

Prospective modifications to the neutrality provisions of the RCP are likely enforceable through partnership and other agreements with CalPERS partners and managers. Both firms agree that partners and managers, as employers, have free-speech rights protected by the Constitution. These rights, however, are subject to waiver and thus the employer may agree to forego its rights to speak to organizing efforts. Although the firms disagree to some extent on the source of the requirement, they agree that such a waiver must be "clear and unmistakable."[6] Thus, new and amended partnership

[4] See Altshuler opinion at pp. 5-8; Steptoe opinion at pp. 12-15.

[5] Altshuler opinion at pp. 7-8.

[6] The Altshuler firm advises that this standard is more loosely applied when the contracting parties are sophisticated and have relatively equal bargaining power, as in the case of

agreements should clearly and unmistakably contain a requirement of "neutrality" to be enforceable and should expressly define the term. This may be accomplished by a clear promise in the partnership or venture agreement by the partner to abide by the terms and conditions of the RCP. This includes provisions that require compliance by the partners' contractors and agents. If these requirements are set forth in an amendment to an existing contract, it must be supported by consideration.[7]

C. Enforcement of RCP Neutrality Provision Changes Through Existing Partnership And Other Agreements

The current RCP requires that all partnership and venture agreements incorporate the provisions of the RCP. If CalPERS amended the current RCP, it is not clear that these changes could be enforced under the existing partnership and other agreements which obligate the advisors, partners, and managers of CalPERS to adhere to the terms of the RCP.

Initially, the Steptoe firm analyzes the enforcement provisions of the RCP. The Board changed the RCP in 2005 to add enhanced remedies. This iteration of the policy allows CalPERS to "cancel [] the service contract" or take "other action" for RCP non-compliance. Provided that "non-compliance" with the policy can be established, the Steptoe firm concludes that action on the partnership contract is most likely authorized for those partnership agreements executed after August 2005.[8]

The Steptoe firm also opines that because a "neutrality" waiver must be clear and unmistakable, it is unlikely a court would find that existing partnership agreements, whether executed before or after 2005, incorporate an obligation to adhere to changes in the neutrality provisions. The current RCP merely states that CalPERS "support[s]" a "position of neutrality" – it does not require it. Any unilateral change to an existing contract must be within the reasonable expectations of the parties at the time of contracting and, of course, must comport with the concept of "good faith and fair dealing." Steptoe concludes that an agreement to comply with the RCP in the form at the time of contracting does not reasonably include appreciable changes in the neutrality provisions. Because the existing RCP states that neutrality is

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CalPERS real estate partners, joint venturers, and their contractors and agents. See Altshuler opinion at p. 14.

[7] Altshuler opinion at pp. 15, 17-18.

"Consideration" means a right, interest or benefit accruing to one party, or a forebearance, detriment, duty, or loss undertaken by the other. Under California law, consideration must be a "bargained-for exchange" between the contracting parties.

[8] See Steptoe opinion at p. 5. The firm reaches a contrary conclusion for those agreements executed before this date. Steptoe opinion at pp. 6-7

the "position" of CalPERS, significant changes to these provisions were probably not within contemplation of the parties at contracting.[9]

The Altshuler firm disagrees to some extent with these conclusions. If the partnership agreements currently incorporate future modifications to the RCP and these modifications are within the reasonable contemplation of the contracting parties, then they should be enforceable. The Altshuler firm opines that a court could find that additional specificity to the neutrality provisions, additional remedies, and similar terms were within the original contemplation of the parties.[10] However, stronger terms, such as binding arbitration or cancellation of the partnership agreement itself, probably do not fall within these parameters.[11]

D. Potential Liability For Remedial Enforcement Of Non-Binding RCP Provisions

Legal enforcement of the terms of the RCP, whether through litigation or remedial action by CalPERS, is premised upon an agreement by the advisors, partners, and contractors of CalPERS. If CalPERS unilaterally attempted to enforce modified neutrality requirements through heightened remedies or penalties, such as partnership contract termination, there is some risk of legal exposure.

The Steptoe firm opines that CalPERS actions could form the basis of a "contractual interference" claim on the part of affected prime and sub-contractors. Citing to a pair of California cases, the firm concludes that if CalPERS acted to terminate a partnership agreement, the contractors and sub-contractors of the partnership could claim that CalPERS interfered with their contracts with the partnership.[12]

The Altshuler firm agrees that if CalPERS unilaterally induces a partner or other party to disrupt or breach an agreement between the partner and a third party, then CalPERS would risk exposure to a claim for interference with contractual relations. Thus, if any new terms of the RCP are not included within the original contemplation of the parties (as explained above), then

[9] In reaching this conclusion, the Steptoe firm primarily cites to a Delaware decision in which the general partner sought to subordinate the rights of existing investors to attract new capital to the venture. Even though the partnership agreement allowed the general partner to sell new partnership interests on terms and conditions set by the general partner, the court held that this did not authorize the general partner to alter substantial investment rights of the existing partner without their consent. See Steptoe opinion at pp. 6-7, 11.

[10] The firm's conclusion is not altered by the potential ambiguities in some provisions of the RCP. Altshuler opinion at p. 16.

[11] See Altshuler opinion at pp. 16-17.

[12] See Steptoe opinion at pp. 5-6.

action that causes damages to third parties through breach or disruption of a contractual relationship may give rise to liability in tort.[13]

III. Fiduciary Counsel Opinion

The Board's fiduciary counsel has also submitted a short opinion on fiduciary considerations. Counsel first observes that the Board and its staff have two primary duties: (1) the duty of loyalty and (2) the duty of prudence. These duties apply to investment decisions and generally require CalPERS to make decisions that are intended to maximize risk-adjusted rates of return. This goal – the "Program Goal" in the parlance of fiduciary counsel – if subordinated to other goals too much, would result in a risk of fiduciary liability. In deciding whether to change the RCP, fiduciary counsel advises that the Board should consider whether these changes would positively or adversely affect the following:

- the investment opportunities available to CalPERS;
- overall investment performance;
- the level of administrative expenses;
- effective use of resources; and
- potential liability under federal and state law.

Fiduciary counsel concludes that if the Board appropriately considers all relevant factors and reasonably concludes that changes to the RCP would (1) either enhance or not degrade investment returns and opportunities, (2) not cause CalPERS to spend too much in the way of administrative expenses, and (3) not result in other detriments (such as legal liability), then adoption of changes to the RCP should be consistent with the Board's fiduciary duties.

[13] Notably, the Altshuler firm makes several other observations in this context. First, intentional inducement of a party's refusal to enter into a new contract or financial arrangement is not covered by this type of claim because the conduct does not cause interference with an existing contract. Further, it is unlikely that CalPERS could face exposure for interfering with "prospective economic advantages" of a partner or other party because there must be underlying "wrongful" conduct. Finally, the Altshuler firm opines that state labor laws are not likely implicated by this conduct. See Altshuler opinion at pp. 18-24.

IV. Conclusion

This memorandum summarizes in succinct form the opinions of outside counsel. These lawyers will attend the workshop and make short presentations. They will also be available for questions during the workshop.

Please contact me directly with any questions.

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CC: Steve Wheeless

RE: Legal Issues Posed by Changes to Responsible Contractor Program Policy

DATE: November 11, 2008

This memorandum analyzes some of the legal issues presented by two potential changes to the CalPERS Responsible Contractor Program Policy ("RCP"): (1) strengthening the enforcement mechanisms and authorized penalties for violation of the RCP, and (2) adopting a more specific neutrality provision as part of the RCP.[1]

I. Proposed Modifications to RCP

A. Enhanced Enforcement

1. Current Enforcement Provisions

The current RCP (effective August 15, 2005)[2] requires inclusion of the RCP's terms in all

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[1] This memorandum does not address the fiduciary responsibility issues that may be raised by the proposed modifications to the RCP.

[2] Unless otherwise indicated, all references to the RCP are to the August 15, 2005 version.

contracts, provides that "Responsible Contractor compliance will be part of the advisor[']s or partner[']s contract renewal consideration," and warns that "Non-compliance will be reported to the System's Board on a timely basis or at a minimum annually." RCP, §VI.D. It further sets forth that non-complying partners, advisors or property managers will be placed on a "watch list" and, if an RCP violation is part of a "pattern of conduct," that this pattern shall be considered when the contract is up for renewal. RCP, §VI.N.

The RCP also outlines a process for investigation of a specific complaint: Complaints may be filed in writing. RCP, §VI.O., App. 2. CalPERS staff logs the complaint in the Responsible Contractor Complaint/Concern Log; contacts the complaining party for additional information; may disclose the complaint to the contractor; works with the partner or advisor "to fully understand the matter" including by review of the service vendor's payroll and employee records, certification, and pattern of conduct; contacts the complaining party again to clear up factual disputes and make sure the nature of the complaint is fully understood; and issues a decision. *Id.*, App. 2. CalPERS staff is granted authority to "take the appropriate action which may include cancellation of the service contract, require re-bidding of the service contract, or other action, as necessary." *Id.*

RCP versions prior to March 11, 2005 did not include these provisions establishing how complaints are processed and authorizing certain remedies with respect to a service contract upon a finding of RCP non-compliance.

2. <u>Potential Changes</u>

A number of different areas of potential changes to RCP enforcement and penalties have been proposed.

First, there are concerns that the existing complaint and investigation process may not provide for adequate fact-finding and investigation. To address these concerns, the RCP could be modified to provide for CalPERS staff or board members to hear evidence directly in a hearing; to authorize a staff investigation that includes communications not only with the complaining party and partner but also with, for example, the service vendor and its employees; and/or to grant authority to a third-party monitor to investigate and make findings regarding alleged RCP violations by a service vendor, contractor, manager, advisor or partner. The RCP might also authorize ongoing monitoring by CalPERS staff or a neutral third party when complaints have been made or found valid. Finally, the RCP could provide for binding arbitration in the event that disputes over compliance arise.

Second, CalPERS may need additional remedies and penalties against partners who fail to comply with the RCP (including by failing to make sure that their service contractors abide by

the RCP).[3] Those remedies could include termination of existing partner contracts, a prohibition of partner contract renewals or extensions, and a ban on additional investment funds. Additionally, it may be helpful to guide the discretion of CalPERS staff in deciding whether a violation of the RCP justifies a remedy or penalty and, if so, which remedy or penalty, by outlining more specific compliance standards.

Third, some have proposed that CalPERS could minimize the number and magnitude of problems that may arise in the future by exercising more aggressive due diligence before investments are made and partner agreements reached – that is, by actively investigating the labor record of potential partners and their contractors prior to reaching an agreement with a prospective partner, and through active consideration of this record as part of the decision whether to invest.

Finally, certain changes could help to avoid any ambiguity regarding awareness by all contracting parties of the RCP's requirements and that it is subject to unilateral modification by CalPERS. For example, the revised RCP should unambiguously require CalPERS staff to incorporate it into all partner and advisor agreements; require CalPERS partners and advisors to incorporate it into all contractor agreements; and require contractors to incorporate it into all subcontractor agreements. The RCP could also mandate more specifically that all contracts and subcontracts contain language stating explicitly that CalPERS staff have the authority to require early termination of an existing contractor or subcontractor arrangement for violation of the RCP. In addition, the revised RCP should state that it applies to all existing contracts that incorporate the RCP and recognize CalPERS' ability to unilaterally modify the RCP. And the revised RCP should be provided to all relevant contract partners, advisors, and managers, as well as their contractors and subcontractors.

B. Modification of Neutrality Policy

1. Current Policy

The RCP provides: "The System supports a position of neutrality in the event there is a legitimate attempt by a labor organization to organize workers employed in the construction, maintenance, operation, and services at a System owned property." RCP, §VI(M).

Some have apparently interpreted this policy not to require partners and advisors, or their contractors and subcontractors, to remain neutral in the event of an organizing campaign. Rather, they construe the policy simply to state that CalPERS itself will have a neutral position.

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[3] As set forth in Appendix 2 to the RCP, remedies against service contractors already include cancellation or re-bidding of the service contract. It may make sense to state these authorized remedies in the body of the RCP rather than just in the appendix.

However, by its terms the RCP (which includes this neutrality provision) applies not only to advisors or partners but also to "joint ventures and partnerships where CalPERS owns a greater than 50% ownership interest (and associated advisor or partner and subcontractor contracts and bids arising out of those investments)." *Id.*, §VI.A; *see also id.*, §VI.E.2.f. (partners' responsibilities include certification that partner, agents, and subcontractors have complied with RCP). Additionally, "[w]hen the Policy is not applicable by its terms, partners or advisors shall be encouraged to make a good faith effort to comply with the spirit of the policy, consistent with their fiduciary duty." *Id.*, §VI.A. Thus, the RCP is most fairly read to extend CalPERS' support for a position of neutrality beyond itself to partners, advisors, joint ventures, contractors and subcontractors.

That reading is supported by the essential logic of the position. If a union were seeking to organize workers at a CalPERS-owned property, it would be of little or no import whether CalPERS itself supported, opposed, or remained neutral with respect to the organizing effort. Thus, the provision would be somewhat meaningless. What matters is whether the workers' employer – be that a CalPERS partner or joint venture, or a contractor or subcontractor of same – will remain neutral.

2. Modification of Neutrality Policy

Dispute over the meaning of the existing language has led to proposals to modify the RCP to be more specific regarding the neutrality requirement. The RCP could be modified to add, for example, language along the following lines: "To protect CalPERS' proprietary interest in avoiding risk to its investments posed by labor disputes, partner and advisor agreements shall include the partner's and advisor's agreement to remain neutral in the event there is a legitimate attempt by a labor organization to organize workers employed in the construction, maintenance, operation, or services at a System-owned property, as well as a commitment to ensure that all contractors and subcontractors agree to remain neutral in such an event." The RCP could require the inclusion of similar language in all contracts and subcontracts.

In addition, it may make sense to define "neutrality." One possible definition, for example, could be as follows: "'To remain neutral' means to not take any action or make any statement that will directly or indirectly state or imply any support for or opposition by the partner, property manager, or contractor to the selection by employees of a collective bargaining agent, or preference or opposition to any particular union as a bargaining agent." In addition, a revised neutrality provision could prohibit retaliation against employees based on their support for or opposition to a particular collective bargaining agent.

Some have suggested, as an alternative or in addition to a "neutrality" requirement, a provision requiring partners, advisors, property managers, or contractors to agree to "labor peace

agreements" upon request by a labor organization that seeks to organize workers at a CalPERS-owned property. "Labor peace agreements" are a means that businesses, government entities, and others have used to avoid the financial risk posed by the potential for disruption attributable to labor disputes; in order to safeguard their interests, some government entities and businesses have required their contractors to show that they have entered such labor peace agreements. Labor peace agreements may contain a variety of substantive provisions, but are typically characterized by a union's agreement to refrain from certain economic actions that threaten the profitability of the business at issue (such as strikes and boycotts), an employer's agreement to avoid certain means of influencing employees about unionization, and a streamlined process (such as binding arbitration) to resolve disputes. Some labor peace mandates may be fulfilled by a collective bargaining agreement that contains a no-strike provision, when the workforce at issue is already unionized.

## II. Federal Issues Presented by Changes

### A. National Labor Relations Act ("NLRA") Preemption

#### 1. Neutrality policy changes

Employers are free to enter voluntary, enforceable agreements to remain neutral in relation to a union's effort to organize their workforce. *See, e.g.*, *International Union, United Automobile, Aerospace, & Agricultural Implement Workers v. Dana Corp.*, 278 F.3d 548, 558 (6th Cir. 2002) ("[A]n employer's voluntary agreement to silence itself during union organizing campaigns does not violate federal labor policy"); *Hotel & Restaurant Employees Union Local 217 v. J. P. Morgan Hotel*, 996 F.2d 561, 564-67 (2d Cir. 1993) (neutrality agreement enforceable in federal court); *Hotel Employees, Restaurant Employees Union, Local 2 v. Marriott Corp.*, 961 F.2d 1464, 1469-70 (9th Cir. 1992) (same; "Nothing in the relevant statutes or NLRB decisions suggests employers may not agree to remain silent during a union's organizational campaign – something the employer is certainly free to do in the absence of such an agreement.").

Here, however, the issue is not simply a private neutrality agreement between an employer and a union, but action by a governmental entity (CalPERS) to pressure and/or require a private employer (a partner, advisor, contractor, or subcontractor) to enter a neutrality or labor peace agreement. Thus, NLRA preemption doctrines that apply to state and local government action become relevant.

*Garmon* preemption doctrine precludes state and local governments from regulating activity that the NLRA protects or prohibits. *See Wisconsin Dept. of Industry v. Gould, Inc.*, 475 U.S. 282, 286 (1986). And under *Machinists* preemption doctrine, state and local governments may not regulate activity that Congress intended to be "unregulated because left to be controlled

by the free play of economic forces." *Machinists v. Wisconsin Employment Relations Comm'n*, 427 U.S. 138, 144 (1971) (internal quotation marks omitted).

These NLRA "preemption doctrines apply only to state *regulation*." *Building & Constr. Trades Council of Metropolitan Dist. v. Associated Builders & Contractors*, 507 U.S. 218, 227 (1993) ("*Boston Harbor*") (emphasis in original). When a state entity acts not as a regulator but instead as a "market participant with no interest in setting policy," in the service of proprietary objectives, its actions are not preempted. *Id.* at 229; *see also id.* at 232 (noting challenged action was tailored to particular job and served efficiency and effectiveness goals). "In the absence of any express or implied indication by Congress that a State may not manage its own property when it pursues its purely proprietary interests, and where analogous private conduct would be permitted, the Court will not infer such a restriction." *Id.* at 231-32. Thus, in *Boston Harbor*, the Court upheld a bid specification requiring potential subcontractors on a state construction project to agree to abide by a project labor agreement that required the hiring of union labor and sought to avoid disruption of the construction project. *Id.* at 221-22, 232-33; *see also Hotel Employees & Restaurant Employees Union, Local 57 v. Sage Hospitality Resources, LLC*, 390 F.3d 206, 216-17 (3d Cir. 2004) (city's conditioning of tax increment financing upon neutrality agreement not preempted when city had proprietary interest as partner in bond issuance).

In *Chamber of Commerce of the United States of America v. Brown*, 128 S.Ct. 2408, 2412 (2008), the Supreme Court deemed a California law that prohibited the use of state funds to support or oppose unionization efforts to be preempted under *Machinists* doctrine. The Court reasoned that Section 8(c) of the NLRA "manifested a congressional intent to encourage free debate on issues dividing labor and management," and that the state law served a *policy* objective that was contrary to this congressional intent. *Id.* at 2413-14 (internal quotation marks omitted); *see also id.* at 2414 (citing other NLRA provisions as further evidence of congressional intent). The Court found evidence of that contrary policy objective in the California law's preamble, which the Supreme Court read to say that partisan employer speech necessarily interfered with employee free choice. *Id.*

Although no party argued that California had operated in a proprietary rather than regulatory capacity when enacting the challenged law, the Supreme Court explained that the state law did not seek to accomplish "the efficient procurement of goods and services," but rather to "further[] . . . a labor policy." *Chamber of Commerce*, 128 S.Ct. at 2415. Because "California plainly could not directly regulate noncoercive speech about unionization by means of an express prohibition[, i]t is equally clear that California may not indirectly regulate such conduct by imposing spending restrictions on the use of state funds." *Id.* at 2414-15; *see also Gould*, 475 U.S. at 287-89 (state prohibition on purchase of goods and services from certain NLRA violators preempted by NLRA even though accomplished through spending power, when purpose of prohibition was regulatory).

Under this precedent, CalPERS may not act in a regulatory capacity to require its partners or their contractors and subcontractors to remain neutral or to have labor peace agreements. However, as a market participant (that is, in this instance, as an investor and property owner), CalPERS may act in the service of its proprietary objectives. Thus, to the extent that CalPERS seeks to require neutrality or labor peace in order to avoid risks to its investment return that could be posed by labor disputes, its actions would not be preempted. For this reason, CalPERS may want to make findings or otherwise make clear its view that disputes over unionization at CalPERS-owned properties present a potentially serious threat to investment returns.

In addition, in determining whether CalPERS' neutrality policy serves a proprietary objective, courts will consider the scope of the governmental action at issue as evidence of the objectives and intent of the policy. *See Healthcare Ass'n of NY State, Inc. v. Pataki*, 471 F.3d 87, 109 (2d Cir. 2006) (citing *Cardinal Towing & Auto Repair, Inc. v. City of Bedford*, 180 F.3d 686, 693 (5th Cir. 1999)). Thus, it will be important that the CalPERS policy applies only to union organizing efforts that take place among employees who work at CalPERS-owned properties (and not, for example, to union efforts to organize employees who work for a partner's contractor at other properties). *Compare Gould*, 475 U.S. at 229 (holding preempted statute that "addressed employer conduct unrelated to the employer's performance of contractual obligations to the State" and served no plausible proprietary objective); *Metropolitan Milwaukee Ass'n of Commerce v. Milwaukee County*, 431 F.3d 277, 279-80 (7th Cir. 2005) (striking down ordinance requiring labor peace agreements that applied to contractors' employees who did no work for county); *Sage Hospitality Resources*, 390 F.3d at 217-18 (ordinance requiring only projects receiving tax increment financing to sign labor agreements "is not unduly broad in promoting and protecting the City's proprietary interest" and "is specifically tailored to protect its proprietary interest in the value of the tax-revenue-generating property"); *Building & Construction Trades Dept., AFL-CIO v. Allbaugh*, 295 F.3d 28, 35 (D.C. Cir. 2002) (explaining that earlier decision held executive order "regulatory . . . because it disqualifies companies from contracting with the Government on the basis of conduct unrelated to any work they were doing for the Government").[4]

Two other factors were important to the Supreme Court's conclusion in *Chamber of Commerce* that the challenged California law was preempted: first, the Court noted that the law specifically permitted the use of state money "for *select* employer advocacy activities that promote unions"; and second, the Court concluded that the law imposed compliance costs and

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[4] Courts will not necessarily accept a public entity's articulated proprietary rationale, but will inquire whether the policy adopted actually serves that purported purpose. *See, e.g., Metropolitan Milwaukee Ass'n of Commerce*, 431 F.3d at 280 (concluding that ordinance did not actually serve purported goal of preventing work stoppages); *Healthcare Ass'n of NY State*, 471 F.3d at 103-05 (questioning whether prohibition on certain uses of government funds served purported cost savings and service quality rationales and requiring further fact-finding on issue).

litigation risks that would make it difficult for employers to use private funds for union-related advocacy. *Chamber of Commerce*, 128 S.Ct. at 2415-16 (emphasis in original). Therefore, CalPERS should avoid adopting exemptions that permit employer advocacy on behalf of unions, and make sure that the compliance and enforcement provisions are not so extensive that they effectively require CalPERS partners and contractors to remain neutral with respect to union organizing efforts that occur on property that is not owned by CalPERS.

2. <u>Enhanced enforcement of RCP</u>

In general, the enhancement of enforcement mechanisms and penalties should not raise NLRA preemption issues, with one caveat. In order to avoid preemption, it may be important to preserve the discretion of CalPERS to consider its proprietary interests as part of determining the appropriate remedy for certain violations of the RCP. That is because, if the provision of the RCP being enforced is a provision that would be NLRA-preempted if CalPERS were acting in a regulatory rather than proprietary capacity,[5] the nature of the enforcement mechanisms and potential remedies could be relevant to determining in which capacity (regulator or proprietor) CalPERS has acted.

Thus, for example, if a subcontractor's violation of the RCP's neutrality provision *automatically* led to termination of a partnership agreement – regardless of the harm to CalPERS' proprietary investment interests that would result from such termination – a court would likely conclude that the CalPERS policy furthered a regulatory rather than proprietary purpose. The remedial provisions of the RCP thus should permit the financial interests of CalPERS and financial consequences of various remedies to be taken into account in deciding appropriate penalties for RCP violations.

B. <u>Other NLRA Issues</u>

It is very unlikely that CalPERS' or its partners' implementation or enforcement of the RCP would involve conduct in violation of the NLRA. For example, while Section 8(a)(2), 29 U.S.C. §158(a)(2), prohibits employer domination of or interference with labor organizations, that provision is not offended by an employer's neutrality, expression of preference for a particular outcome (including that employees will choose representation by a particular union), or non-discriminatory cooperation with union organizing efforts by, for example, granting a labor organization access to its property or lists of employees. *See NLRB v. Englander Co.*, 260 F.2d 67, 76 (9th Cir. 1959) ("[T]he First Amendment guarantees the employer his right to express his preference in a labor dispute. This showing of preference is lawful so long as it falls short of restraint or economic coercion"); *Kimbrell v. NLRB*, 290 F.2d 799, 802 (4th Cir. 1961) (same);

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[5] Certain provisions of the RCP would be permissible even if they were regulatory, of course. For example, minimum labor standards do not trigger preemption. *See Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 756-58 (1985).

*Tecumseh Corrugated Box Co.*, 333 NLRB 1, 3, 6 (2001) (permitting union to address employees on company time and property does not constitute unlawful assistance); *New England Motor Freight Inc.*, 297 NLRB 848, 851-52 (1990) (similar); *see also NLRB v. Midwestern Personnel Servs., Inc.*, 322 F.3d 969, 977-78 (7th Cir. 2003) ("[T]he gravamen of the violation is whether the employer's assistance reasonably tends to coerce the employees in the exercise of their organizational rights").[6] In fact, as previously discussed, courts have consistently held neutrality agreements not only lawful but enforceable in federal court. *See supra* at 5.[7]

CalPERS also would not likely be held liable for violation of NLRA Section 8(e), 29 U.S.C. §158(e). Section 8(e) prohibits "hot cargo" agreements, which are agreements between a labor organization and an employer to cease doing business with another employer (for example, an agreement between a union and an employer not to do business with non-union employers). Violations of Section 8(e) do not give rise to a civil action, but simply a charge before the National Labor Relations Board. Because CalPERS is neither a "labor organization" nor an "employer" under the NLRA, *see supra* note 7, it could not violate this provision. 29 U.S.C. §158(e). In any event, even for partners and contractors that are NLRA employers, Section 8(e) is violated only by an *agreement* with a union. Thus, to avoid liability, an NLRA employer would need to make sure not to enter an express *or* implied agreement with a union to cease doing business with another employer; an employer's unilateral decision to cease doing business based upon the RCP would not offend this prohibition.

The federal statutory prohibition on unlawful secondary activity (sometimes called "secondary boycotts") makes it an unfair labor practice for a labor organization or its agent to

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[6] An employer could violate Section 8(a)(2) by discriminating in favor of one labor organization over another by, for example, granting one union access to its property but denying such access to another. *See, e.g., Price Crusher Food Warehouse*, 249 NLRB 433, 439 (1980). An employer's active assistance to a union in obtaining authorization cards, assignment of employees to assist a union's organizing effort, or convening of a meeting between the union and employees at which supervisors are present could also violate Section 8(a)(2). *See Packing House & Indus. Servs. v. NLRB*, 590 F.2d 688, 694 (8th Cir. 1978) (employer assisted in efforts to solicit signed cards during work time); *Windsor Place Corp.*, 276 NLRB 445, 448-49 (1985) (same); *NLRB v. Keller Ladders S., Inc.*, 405 F.2d 663, 667 (5th Cir. 1968) (employer designated employees to help union organizing effort); *NLRB v. Vernitron Elec. Components, Inc.*, 548 F.2d 24, 26 (1st Cir. 1977) (convening meeting at which supervisors present); *Duane Reade, Inc.*, 338 NLRB 943, 943-44 (2003) (same).

[7] CalPERS itself need not worry about violating Section 8(a) of the NLRA for an additional reason: It prohibits only "employer" domination or interference. 29 U.S.C. §158(a). While the definition of "employer" includes persons acting as agents of an employer, that definition specifically excludes states and political subdivisions of states, including CalPERS. *Id.*, §152(2).

threaten, coerce, or restrain any person in order to force one person to cease doing business with another. *Id.*, §158(b)(4)(ii)(B). The RCP would not call for activities that have been found to offend this provision, such as secondary picketing and bannering; publicity campaigns and other First Amendment speech directed at neutral employers do *not* violate the prohibition on secondary conduct. *See Edward J. DeBartolo Corp. v. NLRB*, 463 U.S. 147, 153-54 (1983). In any event, while labor organizations have been held liable for acts by their agents, agents that are not themselves NLRA employers have not been held liable for violating this provision.[8]

Section 303 of the Labor Management Relations Act authorizes a person injured by unlawful secondary activity to bring a civil action for damages, but only against labor organizations. 29 U.S.C. §187(a); *see also Cranshaw Construction of New England, LP v. International Ass'n of Bridge, Structural & Ornamental Ironworkers, AFL-CIO, Local No. 7*, 891 F. Supp. 666, 673 (D. Mass. 1995) (union's agent may not be held individually liable under Section 303, which "permits only the recovery of damages from a labor organization"). Therefore, even if CalPERS for some reason was involved in unlawful secondary conduct, it would not be exposed to a damages action. And if CalPERS itself were targeted by unlawful secondary activity, it would have the right to bring an action for damages under this provision. *See* 29 U.S.C. §187(b) (granting right of action to "[w]hoever shall be injured in his business or property").

C. <u>First Amendment</u>

A direct government prohibition on employer speech in favor of or opposed to unionization efforts could violate the First Amendment. *See Thomas v. Collins*, 323 U.S. 516, 537-38 (1945). However, when the government acts as a contracting party, its interest in imposing a speech restriction may outweigh a contractor's First Amendment rights. Thus, CalPERS' proprietary justification for requiring neutrality by its investment partners and advisors, as well as their contractors and subcontractors – protecting its investment return – would provide a basis for avoiding First Amendment problems.

First Amendment protection of speech has less force in the workplace than in other contexts, and can be outweighed by strong countervailing interests. *See, e.g., NLRB v. Gissel Packing Co.*, 395 U.S. 575, 617 (1969) (employer's free speech rights do not outweigh

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[8] NLRA agency determinations are guided by ordinary common law agency principles. *See International Longshoremen's Ass'n, AFL-CIO v. NLRB*, 56 F.3d 205, 212 (D.C. Cir. 1995). Under those principles, "an agency relationship arises only where the principal 'has the right to control the conduct of the agent with respect to matters entrusted to him.'" *Id.* at 213 (quoting Restatement (2d) of Agency §14 (1958)). Thus, CalPERS would be considered an agent of an NLRA employer or labor organization only if the employer or labor organization had the right to control CalPERS' conduct.

employees' right to free association). And when the government acts as a contractor or employer, it may impinge on employees' or contractors' speech interests so long as the government's interest (for example, in the efficiency of the workplace) outweighs the value of the speech at issue. *See Board of County Comm'rs, Wabaunsee County v. Umbehr*, 518 U.S. 668, 675-76, 678 (1996) (government may impinge on the speech interests of employees and contractors so long as government's interest in efficiency outweighs value of speech at issue). Courts have often applied this standard to hold government speech restrictions upon contractors or employees not to violate the First Amendment. *See, e.g., Connick v. Myers*, 461 U.S. 138, 146 (1983) ("government officials should enjoy wide latitude in managing their offices" when speech at issue is about internal employment concerns); *Sullivan v. Ramirez*, 360 F.3d 692, 701-02 (7th Cir. 2004) (government's interest in maintaining workplace harmony and morale outweighed employees' interest in speech about possible time abuse by government employees); *Greer v. Amesqua*, 212 F.3d 358, 372 (7th Cir. 2000) (city's interest in maintaining discipline in workplace outweighed firefighter's interest in speech); *Baty v. Willamette Indus., Inc.*, 172 F.3d 1232, 1246-47 (10th Cir. 1999) (imposition of Title VII liability based on speech in workplace does not violate First Amendment), *overruled on other grounds*, *National R.R. Passenger Corp. v. Morgan*, 536 U.S. 101, 122 (2002); *EEOC v. Preferred Mgt. Corp.*, 216 F.Supp.2d 763, 808-09 (S.D. Ind. 2002) (referencing "the well-settled principle that speech which may be unassailable in the streets – even if provocative or repugnant – is not necessarily protected in the workplace"; courts have upheld anti-discrimination intrusions upon speech interests of private employers); *Robinson v. Jacksonville Shipyards, Inc.*, 760 F. Supp. 1486, 1534-36 (M.D. Fla. 1991) (workplace speech that creates hostile work environment not protected by First Amendment; regulation of workplace speech is time, place and manner restriction, workers are captive audience, and countervailing interests can outweigh employee speech rights).

Here, to the extent that CalPERS would be imposing a contractual restriction upon activities that take place at properties it owns in order to protect its investment return by avoiding labor disruption, its interest should outweigh the employer speech right at issue, and the RCP should not prove vulnerable to First Amendment challenge.

## III. State Law Issues Presented by Changes

### A. Applicable Waiver Standard

A heightened waiver standard may apply to a contract provision requiring employer neutrality because of the nature of the right being waived. This would not preclude a partner, advisor, contractor or subcontractor from impliedly assenting to a revised neutrality provision; nor would it prevent CalPERS from incorporating a unilaterally revised RCP into existing contracts as discussed later in this memorandum.

No such heightened standard would apply to a provision making the enforcement

provisions of the RCP more specific.

1. Section 8(c)

A waiver of statutory rights under the NLRA must be "clear and unmistakable." *Metropolitan Edison Co. v. NLRB*, 460 U.S. 693, 707-08 (1983). Section 8(c), 29 U.S.C. § 158(c), provides:

> The expressing of any views, argument, or opinion, or the dissemination thereof, whether in written, printed, graphic, or visual form, shall not constitute or be evidence of an unfair labor practice under any of the provisions of this subchapter, if such expression contains no threat of reprisal or force or promise of benefit.

It is not clear that section 8(c) confers a statutory "right." The plain language of this provision simply clarifies that speech is permissible and cannot be regulated by the NLRB as an unfair labor practice. This is very different from, for example, conferring the right to strike over an unfair labor practice, which was at issue in *Metropolitan Edison*.

Indeed, the NLRA as a whole protects *employees*, not employers. *See* 29 U.S.C. §157 (providing "[e]mployees" with federal statutory rights "to self-organization, to form, join, or assist labor organizations [and] to bargain collectively through representatives of their own choosing."). Section 8(c) does not grant employers speech rights beyond what the First Amendment protects, but rather confirms employers' pre-existing First Amendment rights. *See Gissel Packing*, 395 U.S. at 617 (section 8(c) "merely implements the First Amendment.").

At least one circuit court has expressly held that section 8(c) does not confer a statutory right. In *International Union v. Dana Corp.*, 278 F.3d 548 (6th Cir. 2002), the Sixth Circuit affirmed an arbitrator's construction of an ambiguous neutrality agreement to bar all anti-union speech,[9] and rejected the employer's argument that this construction effected a waiver of its section 8(c) rights:

> In fact, far from recognizing § 8(c) as codifying an absolute right of an employer to convey its view regarding unionization to its employees, we have stated that an expression of an employer's views or opinion under § 8(c) is merely permissible.

[9] The arbitrator interpreted the agreement, which stated that where the United Auto Workers ("UAW") was involved the employer would maintain neutrality, to "preclude *all* anti-union communication – not just anti-UAW communication." *Id.* at 551, 557. The Sixth Circuit affirmed because "the interpretation seems to be a reasonable construction of ambiguous terms." *Id.* at 557-58. No heightened standard was applied.

*Id.* at 559-60 (quotation marks omitted); *see also UAW-Labor Employment & Training Corp. v. Chao*, 325 F.3d 360, 365 (D.C. Cir. 2003) ("[T]he activities described in §8(c) . . . are not 'protected *by*' the NLRA, except from the NLRA itself.") (emphasis in original).[10]

In a recent decision, the Supreme Court characterized section 8(c) as a provision that "protects speech by both unions and employers from regulation by the NLRB." *Chamber of Commerce*, 128 S.Ct. at 2413; *see also id.* at 2414 (section 8(c) "precludes regulation of [noncoercive] speech about unionization"). This language similarly suggests that section 8(c) does not confer a statutory right. And notably, in striking down California's statute requiring employers to remain neutral when using state funds, the Court did not rely on *Garmon* preemption which "forbids States to regulate activity that the NLRA protects, prohibits, or arguably protects or prohibits." *Id.* at 2412.

In sum, a neutrality provision likely does not need to meet a "clear and unmistakable" waiver standard because of section 8(c).

2. First Amendment rights

A heightened standard may still be required to the extent that the neutrality provision implicates First Amendment rights.

As a general rule, California courts have held that "[a] waiver of First Amendment rights may only be made by a 'clear and compelling' relinquishment of them," and that "courts will not imply a waiver of free speech rights." *Integrated Healthcare Holdings, Inc. v. Fitzgibbons*, 140 Cal.App.4th 515, 531-32 (Cal. Ct. App. 2006); *see also Badie v. Bank of America*, 67 Cal.App.4th 779, 804 (Cal. Ct. App. 1998) ("Where it is doubtful whether a party has waived his or her constitutionally-protected right to a jury trial, the question should be resolved in favor of preserving that right.").

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[10] The NLRB has also so interpreted section 8(c). *See Fiber Indus., Inc.*, 267 NLRB 840, 841 n.4 (1983) ("[I]t is well settled that Sec. 8(c) applies only to unfair labor practice proceedings"); *Borden Mfg. Co.*, 193 NLRB 1028, 1034 (1971) (rejecting employers' arguments that their speeches to employees "were protected by Section 8(c) of the Act," and holding that "Section 8(c) is not applicable to representation cases."); *Dal-Tex Optical Co.*, 137 NLRB 1782, 1787 n.11 (1962) ("Congress specifically limited Section 8(c) to the adversary proceedings involved in unfair labor practice cases and it has no application to representation cases."); *General Shoe Corp.*, 77 NLRB 124, 127 n.10 (1948) ("It should be noted that Congress only applied the new Section 8(c) to unfair labor practice cases. Matters which are not available to prove a violation of law, and therefore to impose a penalty upon a respondent, may still be pertinent, if extreme enough, in determining whether an election satisfies the Board's own administrative standards.").

But this principle has not been consistently applied. For example, courts have found that an employee can implicitly assent to resolve all employment disputes by arbitration, even though this waives her constitutional right to a jury trial. *See Craig v. Brown & Root, Inc.*, 84 Cal.App.4th 416, 420 (Cal. Ct. App. 2000).

More significantly, when the parties are sophisticated and the contract was the result of open negotiation, courts consider these factors in applying the heightened standard, and may in fact find an implicit waiver. In *D. H. Overmyer Co. Inc., of Ohio v. Frick Co.*, 405 U.S. 174 (1972), for example, the Supreme Court considered a corporation's claim that it did not validly waive its due process rights. The Court, assuming that a higher standard applied to a "corporate-property-right case," found the standard met, relying in part on the fact that the plaintiff was a large, complex corporation and there was no "unequal bargaining power." *Id.* at 186; *see also People ex rel. Lockyer v. R.J. Reynolds Tobacco Co.*, 107 Cal.App.4th 516, 532-33 (Cal. Ct. App. 2003) (rejecting corporation's argument that contract should be construed against implying its waiver of First Amendment rights in part because "counsel for Reynolds signed the [contract] after good faith settlement negotiations"); *Rifkind & Sterling, Inc. v. Rifkind*, 28 Cal.App.4th 1282, 1290 (Cal. Ct. App. 1994) ("[A]lthough express contractual waivers of due process rights have been required for contracts of adhesion, knowing accession to an agreement that effectively waives such rights has been held sufficient to do so where the parties are sophisticated business people.") (citations omitted).

Here, CalPERS' contracting partners (and their contracting partners) are sophisticated business entities and the contracts are actively negotiated. These are not adhesion contracts or contracts with parties who do not recognize the implications of their actions. Thus, a court may be willing to find an implicit waiver of First Amendment rights. Similarly, the implication of First Amendment rights will likely not prevent CalPERS from incorporating a revised neutrality provision into existing contracts, where reasonably contemplated by the parties. *See infra* at 15-17. As noted previously, the existing RCP expressly discusses neutrality and is most logically read to state that partners, managing agents, and their contractors and subcontractors are expected to remain neutral. So, by agreeing to abide by CalPERS' future revisions of the RCP, the sophisticated partners were well aware that the neutrality provision could be revised and strengthened, and their First Amendment rights could be implicated.

B. <u>Incorporation of Modified RCP into Contracts</u>

So long as the language of the RCP meets any applicable heightened waiver standards, state law would not preclude including the modified RCP in new contracts with partners, advisors, managers, contractors or subcontractors.

The question whether the modified RCP could be applied to *existing* contracts would

depend upon whether language in the existing contract incorporates modifications to the RCP and, if so, whether the modifications of the RCP are within the reasonable contemplation of the contracting parties. If the answer to either of these questions is no, then incorporation of the modified RCP into an existing contract would need to be accomplished by modifying the contract, and additional consideration would be required.

1. Incorporation into existing contracts

If an existing contract contains language that incorporates future revisions to the RCP, no modification of agreements between CalPERS and a partner (or between a partner and its contractors) would be required for changes to the RCP that are within the reasonable contemplation of the parties. For example, if the contract incorporated CalPERS' "then current" RCP, the contract would express an understanding that the incorporated terms would change when CalPERS revised its RCP.[11] The authority of CalPERS to modify the RCP unilaterally, so long as the modification falls within the reasonable contemplation of the parties, may be further supported by past practice, if prior unilateral modifications have been incorporated into existing partner and contractor agreements.[12]

Such a provision, under which CalPERS would reserve the right to unilaterally modify some of the terms of the contract, is valid. *See 24 Hour Fitness, Inc. v. Superior Court*, 66 Cal.App.4th 1199, 1214 (Cal. Ct. App. 1998) (upholding employment contract granting employer right to unilaterally modify employee handbook); *Capano Homes, Inc. v. Syed*, 2008 WL 4182039, at *3 (Del. Super. Sept. 08, 2008) (upholding residential developer's express reservation of right to change model home plan specifications, subject to certain limitations).

Any unilateral modification under such a provision, however, would need to be a modification contemplated by the parties and consistent with the implied covenant of good faith.

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[11] This conclusion is not altered by the RCP's provision that "[a]ll contracts entered into after the effective date of this Policy and pertaining to applicable real estate investments, including renewals of such contracts, shall include the terms of this Policy." RCP, § VI(D). This provision can be read either to require that contracts entered after the RCP's effective date set forth the terms of the RCP in the contract, or to mean that the RCP is incorporated into all contracts entered after the RCP's effective date. Either way, the provision does not bear on what happens when the terms of the RCP are modified while a contract is in force (that is, whether the modifications are incorporated into the existing contract). That issue is addressed instead by the RCP's statement that it "supersedes all previous Responsible Contractor policies," RCP at 1, as well as by the terms of the contracts at issue.

[12] For example, it is our understanding that modifications to the RCP that require changes to the self-certification form have been implemented immediately, and that previous versions of the self-certification form have no longer been used after the RCP modifications' effective date.

*See Badie*, 67 Cal.App.4th at 791 (reservation of right to unilaterally modify is only valid for modifications "whose general subject matter was anticipated when the contract was entered into"); *Powell v. Central Cal. Fed. Sav. & Loan Assn.*, 59 Cal.App.3d 540, 549 (Cal. Ct. App. 1976) ("[T]he fact that one of the parties reserves the power of varying the price or other performance is not fatal if the exercise of this power is subject to prescribed or implied limitations, as that the variation must be in proportion to some objectively determined base or must be reasonable") (quoting *Automatic Vending Co. v. Wisdom* 182 Cal.App.2d 354, 357 (Cal. Ct. App. 1960)).

While courts could reach different conclusions, there would be a strong argument that adopting more specific enforcement provisions and modifying the neutrality provision of the RCP as discussed in this memorandum would be within the reasonable contemplation of the parties.[13] The existing RCP expressly discusses CalPERS' position on neutrality and sets forth the expectation that partners, managing agents, and contractors remain neutral with respect to investment properties. It also provides for penalties for noncompliance. So, by agreeing that CalPERS could unilaterally modify the RCP, the parties would have contemplated that CalPERS might clarify and strengthen the neutrality and enforcement provisions. *Compare Badie*, 67 Cal.App.4th at 795 (by agreeing that one party could unilaterally modify terms of contract, parties did not contemplate modification that added arbitration requirement because this was an "entirely new kind of term to the original account agreements, which did not include any provision regarding the method or forum for resolving disputes"). Similarly, such modifications would not violate the implied covenant of good faith, because CalPERS would not be attempting "to recapture a foregone opportunity by adding an entirely new term that has no bearing on any subject, issue, right, or obligation addressed in the original contract and that was not within the reasonable contemplation of the parties when the contract was entered into." 1 Witkin, Summary

[13] Enforcement of the RCP likely would not be barred by the ambiguity of some of its provisions. "[T]he modern trend of the law favors carrying out the parties' intentions through the enforcement of contracts and disfavors holding them unenforceable because of uncertainty." *Okun v. Morton*, 203 Cal.App.3d 805, 817 (Cal. Ct. App. 1988). To this end, "if the parties have concluded a transaction in which it appears that they intend to make a contract, the court should not frustrate their intention if it is possible to reach a fair and just result, even though this requires a choice among conflicting meanings and the filling of some gaps that the parties have left." *Id.* (quotation marks and alteration omitted). Moreover, the RCP's provisions do provide some guidance. For example, the determination of what constitutes "fair wages" and "fair benefits" is made by looking at "local practices concerning type of trade and type of project," and may involve consideration of "local wage practices, state laws, prevailing wages, [and] labor market conditions." RCP, §VI(J). Thus, although disputes could emerge over the application of certain provisions, the provisions would likely be found sufficiently definite to be enforceable. *See Byrne v. Laura*, 52 Cal.App.4th 1054, 1065-67 (Cal. Ct. App. 1997) (agreement by deceased non-marital partner that he "would take care of" surviving partner enforceable; quantity of support intended by the parties is issue for trier of fact).

10th (2005) Contracts, § 801, p. 895.

Some modifications, however, would likely be held to fall outside this permissible realm. ~~For example, requiring a subcontractor to submit to binding arbitration with a labor organization~~ with which it has a dispute would probably not be within the reasonable contemplation of the parties because the general subject matter would not necessarily have been anticipated. Similarly, while the current RCP contemplates cancellation of service contracts for noncompliance, it does not authorize cancellation of partner agreements. A new provision permitting cancellation of partner agreements for RCP noncompliance could be deemed to authorize a far more serious penalty than would have been within the contemplation of the parties.[14]

2. <u>Contract modification: mutual assent and new consideration</u>

If existing contracts do not incorporate future revisions to the RCP, or if the revisions at issue fall outside the reasonable contemplation of the parties, the contracts will need to be modified for the revised RCP to apply. In general, contract modification requires the agreement of all parties and additional consideration. *See Motown Record Corp. v. Brockert*, 160 Cal.App.3d 123, 133 (Cal. Ct. App. 1984) ("[T]he modification [of a written contract] must be supported by new consideration"). *Continental Ins. Co. v. Rutledge & Co., Inc.*, 750 A.2d 1219, 1232 (Del. Ch. 2000) ("Any amendment to a contract, whether written or oral, relies on the presence of mutual assent and consideration."); *see also* Cal. Civ. Code §1698(a)-(c) (written contract "may be modified by a contract in writing," "by an oral agreement to the extent that the oral agreement is executed by the parties," or, unless contract expressly provides otherwise, "by an oral agreement supported by new consideration"). CalPERS could supply additional consideration by, for example, making an additional investment in the partnership that it was not legally obligated to make, or by changing a contractual right or obligation to benefit the partner.

[14] On the other hand, some partner agreements may already provide that termination is a remedy for any breach of the agreement, regardless of materiality. In such cases, termination could provide a remedy for breach of the RCP's neutrality provision regardless of the RCP's penalty provisions, making it far more likely that a court would deem such a penalty to fall within the reasonable contemplation of the parties.

The question has also arisen whether the RCP's authorization of service contract cancellation as a remedy for RCP noncompliance, in the appendix that was added on March 11, 2005, has been incorporated into pre-March 11, 2005 contracts. While this may depend on the terms of the service contract at issue, a service contractor's violation of the RCP would be more likely held a material breach of its performance obligations under the service contract than would a partner's noncompliance. Because material breaches excuse the other party's performance, *see De Burgh v. De Burgh*, 39 Cal. 2d 858, 863 (1952), this makes it more likely that termination of the service contract would be held to have been within the reasonable contemplation of the parties even prior to March 11, 2005.

Similarly, partners could modify agreements with contractors by providing additional consideration.

Modifications may be~~come effective upon a formal, written acceptance. But no such~~ formal acceptance is required, if the contracting party impliedly assents to the modification by accepting the additional consideration. For example, a partner could impliedly assent to a modified contract term by accepting additional investment funds after CalPERS offered them in exchange for the revised neutrality provision. *See* 1 Witkin, Summary 10th (2005) Contracts, § 195, p. 228-29 ("Where the offeree, with freedom to reject them, makes use of services, or other consideration tendered with the offer, this conduct amounts to an acceptance."). And even a contract provision stating that all amendments must be in writing would not necessarily prevent a partner from impliedly assenting to modify. "'[T]he parties may, by their conduct, waive such a provision' where evidence shows that was their intent." *Biren v. Equality Emergency Medical Group, Inc.*, 102 Cal.App.4th 125, 141 (Cal. Ct. App. 2002) (quoting *Frank T. Hickey, Inc. v. Los Angeles Jewish Community Council*, 128 Cal.App.2d 676, 682-683 (Cal. Ct. App. 1954)); *see also* Cal. Civil Code §1698(d) (statute governing modification of written contracts does not preclude application of waiver rules). This intent could be shown if a partner accepted additional investment funds, for example, with the knowledge that CalPERS offered them in exchange for a revised neutrality provision.

C. Potential Contract Liability

If the modified RCP is not incorporated into the contract at issue, then CalPERS or a partner could breach the contract by terminating the contractual relationship based on violation of the modified RCP (unless, of course, the conduct at issue would also have violated the current RCP and contract termination was an authorized remedy). However, CalPERS' decision not to invest additional funds because of RCP violations, or CalPERS' or a partner's decision not to renew or extend a contract on such grounds, would not breach an existing contract (unless that contract somehow obligated the renewal, extension, or additional investment).

1. Implied covenant of good faith

In addition, the implied covenant of good faith adheres in every contract:

> There is implied in every contract a covenant by each party not to do anything which will deprive the other parties thereto of the benefits of the contract. . . . This covenant not only imposes upon each contracting party the duty to refrain from doing anything which would render performance of the contract impossible by any act of his own, but also the duty to do everything that the contract presupposes that he will do to accomplish its purpose.

*Harm v. Frasher*, 181 Cal.App.2d 405, 417 (Cal. Ct. App. 1960); *see also Dunlap v. State Farm Fire and Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) ("Only when it is clear from the writing that the contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate with respect to that matter may a party invoke the covenant's protections."); Del. Code tit. 6, § 17-1101(d) (limited partnership agreement "may not eliminate the implied contractual covenant of good faith and fair dealing").

Neither enhanced enforcement nor a revised neutrality provision would prevent CalPERS' partners from receiving the benefit of the contract. Indeed, through the incorporated RCP, the contract explicitly contemplates neutrality as part of the original agreement, so enforcement of this principle will not violate the implied covenant of good faith. *Compare Pasadena Live, LLC v. City of Pasadena*, 114 Cal.App.4th 1089, 1093 (Cal. Ct. App. 2004) (implied covenant of good faith violated by city's refusal to let production company submit proposals for events; although contract terms did not obligate city to grant any event permits or consider proposals, contract plainly contemplated that city would consider proposals because otherwise company would have no opportunity to reap benefit of the bargain). As discussed earlier in this memorandum, however, any unilateral modifications to the RCP that are incorporated into existing contracts without the provision of additional consideration must have been within the reasonable contemplation of the parties. *See supra* at 15-17.

2. Control liability

If CalPERS is a limited partner in a partnership, it will open itself to liability for obligations of the partnership if it exercises "control" over the business of the partnership. *See* Cal. Corp. Code § 15632(a) ("A limited partner is not liable for any obligation of a limited partnership unless . . . , in addition to the exercise of the rights and powers of a limited partner, the limited partner participates in the control of the business."); *see also id.* § 15507(a) (same, governing partnerships formed prior to July 1, 1984); Del. Code tit. 6, § 17-303(a) (same).

However, enforcing a neutrality provision or other provisions of the RCP would not constitute control over the business of a partnership. CalPERS would simply be enforcing a contractual term and would not thereby be involved in the management of the investment. Compare, for example, *Holzman v. De Escamilla*, 86 Cal.App.2d 858 (Cal. Ct. App. 1948), in which a limited partnership was formed to operate a farm. The limited partners were held to have exercised control because they "had absolute power to withdraw all the partnership funds in the banks without the knowledge or consent of the general partner," "required [the manager] to resign . . . and selected his successor," and "were active in dictating the crops to be planted." *Id.* at 860.

Moreover, a limited partner who exercises control is only liable as to "persons who transact business with the limited partnership with actual knowledge of that partner's

participation in control and with a reasonable belief, based upon the limited partner's conduct, that the partner is a general partner at the time of the transaction." Cal. Corp. Code § 15632(a); *see also* Del. Code tit. 6, § 17-303(a). Enforcement of the neutrality provision or other provisions of the RCP would not involve business transactions with third parties in which CalPERS might be perceived as a general partner: as we understand it, CalPERS would be enforcing the neutrality provision through its partners, who would then enforce it with third party contractors. Therefore, CalPERS will not be subject to control liability for enforcing a neutrality provision or other parts of the RCP.

D. Potential Tort Liability[15]

If the modified RCP is not incorporated into existing contracts, but CalPERS nonetheless enforces the modified RCP in a manner that leads a partner to breach an agreement with a contractor (or that interferes with some other contractual relationship), it may be subject to tort liability as further explained below. CalPERS' enforcement of the RCP to cause a partner not to renew or extend a subcontractor arrangement would not subject it to such liability.

1. Intentional interference with contractual relations

The elements of intentional interference with contractual relations are:

> (1) the existence of a valid contract between the plaintiff and a third party; (2) the defendant's knowledge of that contract; (3) the defendant's intentional acts designed to induce a breach or disruption of the contractual relationship; (4) actual breach or disruption of the contractual relationship; and (5) resulting damage.

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[15] Under Cal. Govt. Code § 815(a), "[e]xcept as otherwise provided by statute . . . [a] public entity is not liable for an injury, whether such injury arises out of an act or omission of the public entity or a public employee or any other person." "'Public entity' includes the State, the Regents of the University of California, a county, city, district, public authority, public agency, and any other political subdivision or public corporation in the State." *Id.*, § 811.2. CalPERS is "a unit of the State and Consumer Services Agency," *id.*, § 20002, and thus is a public entity immune from tort liability unless provided otherwise by statute, as the California Court of Appeal has held in unpublished (and therefore non-precedential and non-citable) decisions. *Brand v. City of Palo Alto*, 2005 WL 1808417 (Cal. App. Aug. 1, 2005) (finding CalPERS immune from misrepresentation claims); *City of Huntington Beach v. Board of Admin. of Cal. Public Employees' Retirement Sys.*, 2002 WL 1397286, at *7 (Cal. App. Jun. 26, 2002) (finding CalPERS immune from tort claims). There are no statutes making public entities liable for the torts discussed here, so CalPERS would not be directly liable.

CalPERS could still be vicariously liable, however, for the actions of its employees acting within the scope of their employment. *See* Cal. Govt. Code § 815.2; *Zelig v. County of Los Angeles*, 27 Cal. 4th 1112, 1127 (Cal. 2002).

*Reeves v. Hanlon*, 33 Cal. 4th 1140, 1148 (Cal. 2004). "[T]he plaintiff need not prove that a defendant acted with the primary purpose of disrupting the contract, but must show the defendant's knowledge that the interference was certain or substantially certain to occur as a result of his or her action." *Id.* The interference need not induce breach to be actionable; it is sufficient "if plaintiff's performance is made more costly or more burdensome." *Pacific Gas & Electric Co. v. Bear Stearns & Co.*, 50 Cal. 3d 1118, 1129 (Cal. 1990).[16]

All contracts relating to investment properties should already incorporate the RCP. *See* RCP, §VI.A ("This Policy shall apply to all applicable real estate advisors or partners single family real estate investments . . . (and associated advisor and subcontractor contracts and bids arising out of those investments)."), §VI.D ("All contracts entered into after the effective date of this Policy and pertaining to applicable real estate investments, including renewals of such contracts, shall include the terms of this Policy."). If these contracts also contemplate incorporating revised RCPs (by, for example, incorporating the "then current" RCP), and if the changes at issue are within the reasonable contemplation of the parties, CalPERS would not be inducing a breach or disruption of the contract simply by requiring a partner to enforce the terms of the contracts it has with subcontractors.

If these second-tier contracts do not incorporate the RCP or do not contemplate incorporating revised RCPs, or if the changes at issue are not within the reasonable contemplation of the parties, partners could still bind subcontractors to comply with the modified RCP by providing additional consideration and modifying subcontracts under the principles discussed above. *See supra* at 17-18. CalPERS could exercise its influence over a partner to induce that partner to provide such consideration and obtain such a modification.

If a subcontract does not incorporate changes to the RCP and is not amended to include such changes, but CalPERS intentionally takes action to induce a disruption or breach of a partner's relationship with a subcontractor based on the subcontractor's violation of the modified RCP, CalPERS could be subject to tort liability for intentional interference with contractual relations and for the consequential damages of that tort.[17] Notably, however, CalPERS'

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[16] Texas law provides for a similar intentional interference with contract tort. *See Powell Industries, Inc. v. Allen*, 985 S.W.2d 455, 456 (Tex. 1998). So do Arizona and Florida, except that the tort in those states requires an additional element that the interference be unjustified or improper. *See Safeway Ins. Co., Inc. v. Guerrero*, 106 P.3d 1020, 1025 (Ariz. 2005); *Ethan Allen, Inc. v. Georgetown Manor, Inc.*, 647 So.2d 812, 814 (Fla. 1994).

[17] As previously discussed, the current RCP provides for termination of subcontracts as a remedy for RCP violations. RCP, App. 2. Thus, if the subcontractor has violated provisions of the current RCP, and assuming the current RCP is included in the relevant subcontract as required, CalPERS would not commit a tort by causing a partner to breach a subcontract based

inducement of a partner's threat not to renew or extend a subcontract would not involve disruption or breach of the subcontract, and so would not subject CalPERS to tort liability for interference with contract.

The interference with the third-party contract would need to be intentional in order for CalPERS to be subject to tort liability. If a partner were to breach a subcontract even though the breach was not required under its contract with CalPERS, and its breach were not based on any inducement by CalPERS, CalPERS would not be liable for intentional interference with contractual relations, because it will not have known "that the interference was certain or substantially certain to occur as a result of his or her action." *Reeves*, 33 Cal. 4th at 1148; *cf. Quelimane Co. v. Stewart Title Guaranty Co.*, 19 Cal. 4th 26, 34-35, 56-57 (Cal. 1998) (defendant and its co-conspirators were only companies in county offering title insurance and were aware that "ability to obtain title insurance is an important part of any real estate transaction in California"; allegation that defendant knew and intended that its unjustified failure to issue title insurance would necessarily result in buyer's breach of land sale contract with plaintiff was sufficient to state claim).[18]

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on the subcontractor's violation of the RCP. If the subcontract does not include the RCP as required, and CalPERS were sued for intentional interference with contract for inducing a breach of the subcontract, CalPERS might be able to obtain equitable indemnification from the partner that failed to include the RCP in the subcontract as required by the RCP. *See Bay Development, Ltd. v. Superior Court*, 50 Cal. 3d 1012, 1033 n.12 (Cal. 1990) (equitable indemnity claim may arise from "contractual language not specifically dealing with indemnification"); 10 Witkin, Summary 10th (2005) Torts, § 118, p. 220 (implied contractual indemnity "is based on the premise that a contractual obligation to perform carries with it an implied agreement to indemnify against liability to a third party arising from failure to perform").

[18] Negligent interference with contractual relations is not currently a viable cause of action in Arizona, Florida, Texas, or California. *See Fifield Manor v. Finston*, 54 Cal. 2d 632, 636-37 (Cal. 1960); *Chanay v. Chittenden*, 563 P.2d 287, 291 (Ariz. 1977); *Peninsula Federal Sav. and Loan Ass'n v. DKH Properties, Ltd.*, 616 So.2d 1070, 1073 n.4 (Fla. App. 1993); *Exxon Corp. v. Allsup*, 808 S.W.2d 648, 659 (Tex. App. 1991). However, that may change in California. *See LiMandri v. Judkins*, 52 Cal.App.4th 326, 349 (Cal. App. 1997) (noting that *Fifield* has been undermined by subsequent California Supreme Court cases but not expressly overruled); *C & S Real Estate Group, Inc. v. Ramirez*, 2002 WL 472246, at **8-10 (Cal. App. 2002) (Kolkey, J., concurring) (suggesting that, because "subsequent state high court cases cannot be easily reconciled with *Fifield Manor*," California Supreme Court might soon overrule it) (citation omitted).

Even if it were a viable cause of action, however, liability for negligent interference with business relations only arises when there is a "special relationship" between the plaintiff and the defendant creating a duty of care. *See J'Aire Corp. v. Gregory*, 24 Cal. 3d 799, 804 (Cal. 1979)

2. Interference with prospective economic advantage

The elements of intentional interference with prospective economic advantage are:

> (1) [A]n economic relationship between plaintiff and a third party, with the probability of future economic benefit to the plaintiff; (2) defendant's knowledge of the relationship; (3) an intentional act by the defendant, designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) economic harm to the plaintiff proximately caused by the defendant's wrongful act, including an intentional act by the defendant that is designed to disrupt the relationship between the plaintiff and a third party. The plaintiff must also prove that the interference was wrongful, independent of its interfering character.

*Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937, 944 (Cal. 2008) (citations and quotation marks omitted).[19]

Negligent interference with prospective economic advantage is proved by similar elements, except the defendant's act need only be negligent. The interference must still be wrongful. *See Contemporary Services Corp. v. Staff Pro Inc.*, 152 Cal.App.4th 1043, 1060 (Cal. Ct. App. 2007).[20] "An act is independently wrongful if it is unlawful, that is, if it is proscribed by some constitutional, statutory, regulatory, common law, or other determinable legal standard." *Arthur Andersen LLP*, 44 Cal. 4th at 944 (quotation marks and alteration omitted). In other words, it must be "out of the realm of legitimate business transactions." *Gemini Aluminum Corp. v. California Custom Shapes, Inc.*, 95 Cal.App.4th 1249, 1258 (Cal. Ct. App. 2002).

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(discussing duty of care required to state a claim for negligent interference with prospective economic advantage). The relevant factors are: "(1) the extent to which the transaction was intended to affect the plaintiff, (2) the foreseeability of harm to the plaintiff, (3) the degree of certainty that the plaintiff suffered injury, (4) the closeness of the connection between the defendant's conduct and the injury suffered, (5) the moral blame attached to the defendant's conduct and (6) the policy of preventing future harm." *Id.* Here, so long as CalPERS does not intend or reasonably foresee that a transaction affect a subcontractor, CalPERS would not owe a duty of care to the subcontractor. Further, CalPERS' conduct would not be morally blameworthy.

[19] Arizona, Florida, and Texas law provide for a similar intentional interference with prospective economic relations tort. *See Strojnik v. General Ins. Co. of America*, 36 P.3d 1200, 1202 (Ariz. App. 2001); *Ethan Allen*, 647 So.2d at 814; *Ash v. Hack Branch Distributing Co., Inc.*, 54 S.W.3d 401, 414-15 (Tex. App. 2001).

[20] As noted in note 18 *supra*, Arizona, Florida, and Texas do not recognize the tort of negligent interference with business relations, including prospective economic relationships.

CalPERS would not face liability for requiring a partner or managing agent not to award or renew a contract with a prospective subcontractor that refused to remain neutral or otherwise violated the RCP, because CalPERS' conduct would not be wrongful. It is lawful and a legitimate business decision to enforce a neutrality provision. *Compare, e.g.*, *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134, 1159 (Cal. 2003) (wrongful requirement satisfied where defendant "engaged in bribery and offered sexual favors to key Korean officials in order to obtain the contract from the Republic of Korea," thereby violating the Foreign Corrupt Practices Act).

E. State labor laws

The contemplated RCP modifications should not put CalPERS at risk of violating state labor laws prohibiting employer financing or control of labor unions.

California Labor Code § 1122, for example, permits damages actions if an employer "finance[s] in whole or in part, interfere[s] with or dominate[s] or control[s]" an employee group. This provision has been violated by an employer's financial contributions to a particular slate of candidates in an election for union officials, *Hotel & Restaurant Employees etc. Union v. Francesco's B. Inc.*, 104 Cal.App.3d 962, 972-73 (Cal. Ct. App. 1980), or by withdrawing recognition from a previously recognized union and instead recognizing a competing union in whose majority status the employer does not have a good faith belief, *Service Employees Int'l Union v. Hollywood Park, Inc.*, 149 Cal.App.3d 745, 763-64 (Cal. Ct. App. 1983). A neutrality provision does the opposite – it keeps the employer neutral on union organizing matters.

Nor will CalPERS risk liability pursuant to Cal. Labor Code §1126, which provides that common law claims applying to all contracts also apply to collective bargaining agreements. A requirement of neutrality would not entail any interference with a collective bargaining agreement or with the collective bargaining process, so CalPERS would not be exposed to liability for interference with contractual relations on this basis.

STEPTOE & JOHNSON LLP

ATTORNEYS AT LAW

# MEMORANDUM

November 10, 2008

TO: Peter Mixon, General Counsel
Patricia Pechtel, Assistant Chief Counsel

FROM: Steve Wheeless

CC: Stacey Leyton

RE: RCP Workshop Memorandum

On November 18, 2008, CalPERS and certain stakeholders will meet at a Responsible Contractor Program "workshop" to discuss issues and viewpoints related to possible Program modifications. Potential modifications include enhanced grievance and remedy procedures and an expanded definition of RCP "neutrality." You asked us to prepare this memorandum for the workshop participants to educate and inform them about how relevant contract, tort, and labor law principles might affect such possible modifications. We first address the legal principles that might affect changes to RCP enforcement provisions. Then we discuss the legal issues surrounding possible enhancements to the RCP neutrality provision.

## I. WHAT LEGAL PRINCPLES MIGHT AFFECT POTENTIAL CHANGES TO RCP ENFORCEMENT ACTIONS?

### A. The Basic RCP Obligation.

Under CalPERS' Responsible Contractor Program Policy, Part II, CalPERS "supports and encourages fair wages and fair benefits for workers employed by its contractors and subcontractors . . . ." To further those objectives, CalPERS: (1) instructs its real estate advisors and property managers to use "a competitive bidding and selection process" for "construction, maintenance, and services" work that gives "a strong preference [to] Responsible Contractors . . . ." [Parts IV-VI]; (2) defines a Responsible Contractor as one that "pays workers a fair wage and a fair benefit . . . including, but [] not limited to, employer-paid family health care coverage, pension benefits, and apprenticeship [training] programs" [Part III]; (3) invites local Unions to identify – and local contractors and sub-contractors to self-identify as – Responsible Contractors [Part VI.E.]; (4) expects property managers and contractors to invite a reasonable number of potentially eligible Responsible Contractors to submit bids on jobs [Part VI.L.]; and (5) requires its real estate advisors to report annually on RCP compliance (although CalPERS does not mandate any particular compliance system) [Part VI.E.2, VI.N.].

Because CalPERS requires "competitive returns on CalPERS' real estate investments" [Part II], the RCP "avoids a narrow definition of 'fair wage,' 'fair benefits,' and 'training' that might not be practical in all markets." [Part VI.J.] "The Policy does not require a 'prevailing wage,' as defined by government surveys," but looks instead "to local practices," recognizing "that practices and labor market conditions vary across the country and that flexibility in its implementation is very important." [Part VI.J.]

Of note, Housing Development Partnerships do not incorporate the RCP, but voluntary compliance is strongly recommended. [Part VI.A.]

**B. <u>Existing Enforcement Provisions</u>.**

Both the 1998 and 2005 RCP versions state in the title section that the Policy "supersedes" prior policies. Yet both versions state that "all contracts entered into *after* the effective date of this Policy and pertaining to applicable real estate investments, including renewals of such contracts, shall include the terms of *this* Policy" [Part VI.D. (emphasis added)], suggesting a possible prospective application.

The August 12, 1998 RCP does not contain any complaint filing, investigation, or resolution provisions. The August 15, 2005 RCP provides that interested parties may file a written complaint, which CalPERS will log, investigate, attempt to mediate, and resolve. [Part VI.O., App. 2.] (We understand that there were no other substantive RCP changes between 1998 and 2005.)

The "Enforcement" section of both the 1998 and 2005 RCP versions, provides that CalPERS will place non-complying advisors or property managers on "a probation watch list." [Part VI.N.] If the non-complying advisor or property manager does not modify its RCP compliance efforts after consultation with CalPERS staff, CalPERS "will consider that pattern of conduct along with other information when it reviews the advisor or property manager contract for possible renewal." [Part VI.N.]

The 2005 RCP adds a new enforcement remedy to the Complaint processing policy, attached to the RCP as Appendix 2. Although not referenced or discussed in the "Enforcement" section of the RCP itself, the Complaint processing policy attachment provides: "If a violation of the RCP is deemed to have occurred, staff will take the appropriate action which may include cancellation of the service contract, require re-bidding of the service contract, or other action, as necessary." [Part VI.O., App. 2, Step 5.]

**C. <u>Potential Changes To Enforcement Provisions</u>.**

The 1998 version of the RCP does not specify the process by which an advisor or property manager might be placed on a probation watch list. The 2005 version does set forth a Complaint processing procedure. Neither version defines exactly what constitutes RCP compliance except as it relates to notice, reporting, and bidding requirements. Further, what actually constitutes a Responsible Contractor and who qualifies is largely a discretionary matter of self- or union-identification. Likewise, whether a Responsible Contractor is selected after a competitive bidding process is largely a discretionary matter left to the local advisor and property manager. Consequently, CalPERS and its interested stakeholders (the "interested parties") may consider defining a more precise standard for RCP compliance against which CalPERS can

measure advisors and property managers. However, any such standard would have to account for local market conditions and the overarching requirement for competitive returns. With or without a specific compliance standard, the interested parties may consider including a formal ADR procedure to the complaint investigation process, which would give outside stakeholders increased input to and control over compliance decisions.

Under the 1998 version, CalPERS' sole remedy for RCP non-compliance is to consider whether to renew its contract with the non-complying party. That remedy remains the only referenced remedy in the "Enforcement" section of the 2005 version (creating some possible ambiguity as to how the RCP Enforcement section should be interpreted in light of the attached Complaint processing procedure, which has enhanced remedies). Accordingly, the interested parties may consider whether more clearly defined and increased non-compliance penalties are warranted. Conceptually, such penalties (or remedies) might include a ban on follow-on funds, exclusion from new contracts, or even termination of an existing contract.

**D. Relevant Legal Considerations.**

As a threshold matter, CalPERS should confirm that its advisors and property managers are contractually bound by the RCP, which is normally attached as an "exhibit" to an underlying advisor/manager contract. "Parties may incorporate by reference into their contract the terms of some other document [such as the RCP]." *Williams Const. Co. v. Standard-Pacific Corp.*, 61 Cal. Rptr. 912, 920 (Ct. App. 1967). To validly incorporate a document by reference into the basic contract, the reference must be 1) "clear and unequivocal," 2) "called to the attention of the other party and he must consent thereto," and 3) "the terms of the incorporated document must be known or easily available to the contracting parties." *Id.* Here, we assume that CalPERS' advisor/manager contracts all incorporate the RCP in sufficient detail to meet this standard. However, CalPERS must also determine which advisors and property managers entered into existing contracts prior to August 2005 given that the Complaint processing policy was first added to the August 15, 2005 RCP version.

Accordingly, when considering whether and how to modify the RCP, the interested parties should note that different advisors/managers may be bound (or believe they are bound) by different RCP versions. Also, regardless of which version applies, once incorporated, a party cannot generally modify a referenced document [like the RCP] without renegotiating the contract and providing additional consideration. *See e.g.*, Cal. Civ. Code § 1698 (requiring additional consideration for oral modifications to written contracts); *Shaw v. Regents of University of California*, 58 Cal. App. 4th 44, 55 (Ct. App. 1997) (holding that the employer-university could not unilaterally modify a Patent Royalty Payment Policy attached to and referenced in a professor's employment contract because there was no indication in the contract or the Policy that it could or would be changed).

Indeed, even where a contract requires the parties to comply with a "then current policy" attachment or an attachment that "may be amended from time to time," any unilateral amendment to the contract attachment must be within the reasonable contemplation of the parties and must comport with notions of good faith and fair dealing. *Perdue v. Crocker Nat'l Bank*, 38 Cal. 3d 913, 923-24 (1985) (requiring that a party exercising contractually-authorized discretionary power do so in a "reasonable" manner "subject to [the party's] duty of good faith and fair dealing in setting or varying such [terms]"); *see also*, *Badie v. Bank of America*, 67 Cal.

App. 4th 779, 796 (Ct. App. 1998) (discretionary powers conferred on a party by contract must be exercised in accordance with the implied covenant of good faith and fair dealing "to assure that the promises of the contract are effective and in accordance with the parties' legitimate expectations" and that "the essence of the good faith covenant is objectively reasonable conduct"). In addition, if a contracting party attempts to reserve the contractual right to do whatever it wants (*e.g.*, modify the RCP in any way CalPERS wants, imposing whatever terms it wants), the contract may become illusory and unenforceable. *Badie*, 67 Cal. App. 4th at 797 (permitting parties to exercise unilateral rights under change-of-terms provisions "without any limitation on the substantive nature of the change permitted, would open the door to a claim that the agreements are illusory"). Thus, even if CalPERS' advisor/manager contracts contain language anticipating periodic RCP updates, such updates must fall within the parties' original contract expectations to be enforceable.

The analysis may be further complicated here because even if an underlying advisor/manager contract references a "then existing" or "modified from time to time" RCP, both versions of the RCP state that the current version supersedes prior versions, but then later suggest only prospective application ("All contracts entered into *after* the effective date of this Policy . . . shall include the terms of this Policy.") That difference in coverage language (if it exists) likely creates some ambiguity as to which RCP version applies for pre-August 2005 contracts. As noted below, contract ambiguity is generally resolved against the drafting party (presumably CalPERS).[1]

### 1. CalPERS Can Likely Define RCP Compliance Standards And Grievance Filing And Investigation Procedures For Existing Partner Contracts.

Both the 1998 and 2005 RCP versions allow CalPERS to counsel non-complying advisors and property managers and place them on a "probationary watch list." Although the 1998 version does not specify any grievance filing or investigation procedures and neither the 1998 nor the 2005 versions specify criteria for assessing non-compliance, a contracting party would necessarily understand that for CalPERS to counsel and monitor a non-complying advisor or property manager (individually referred to here as an "advisor/manager" or collectively as "advisors/managers"), it would first have to learn of alleged non-compliance (from a third-party grievance, for example), would then have to investigate the allegation, and would finally have to decide if the conduct at issue constituted non-compliance. Thus, the existing 1998 RCP language likely gives CalPERS the right to unilaterally create and impose a formal grievance filing and investigation procedure on advisors/managers that contracted with CalPERS prior to August 2005. (Those that contracted after August 2005 would of course be subject to the August 2005 RCP Complaint processing policy.) For the same reasons, both the 1998 and 2005 RCP versions likely give CalPERS the right to unilaterally define and impose RCP compliance metrics, which would then provide CalPERS an objective framework for placing non-complying advisors/managers on the "probationary watch list."

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[1] The interested parties may want to consider modifying the relevant RCP language to clarify that "All contracts with CalPERS that reference a Responsible Contractor Program (whenever entered into) shall apply this or the most recent published RCP version."

*In re Nantucket Island Assoc. Limited Partnership Unit Holders Litigation* supports that conclusion. 810 A.2d 351, 361 (Del. Ch. 2002).[2] In that case, the court held: "Like other contracts, limited partnership agreements are to be construed in accordance with their literal terms: The terms of the agreement themselves will be controlling when they establish the parties' common meaning so that a reasonable person in the position of either party would have no expectations inconsistent with the contract language." *Id.* Applying that principle, the court rejected one of the plaintiff's contract-ambiguity arguments, holding: "Any reasonable reader of the Prospectus would have known that an affiliate of the General Partner was willing to put up over $10 million of its own money to buy the new Preferred Units. *The inference one would draw from that disclosure* is that the General Partner believed that this was an attractive investment opportunity, even in light of the risks involved." *Id.* at 375 (emphasis added). Here, any reasonable reader of the RCP would know that CalPERS could place an advisor/manager on the "probationary watch list" for RCP non-compliance, and the inference one would draw from that disclosure would be that CalPERS would have to set compliance standards and provide for a process to learn of and investigate non-compliance allegations.

**2. CalPERS Can Likely Impose Specific Non-Compliance Contract Penalties On Post-August 2005 Advisor/Manager Contracts.**

The Complaint processing policy attached to the August 15, 2005 RCP expressly allows CalPERS to "cancel[] the service contract, require re-bidding of the service contract, or [take] other action, as necessary" for RCP non-compliance. Although the August 15, 2005 RCP "Enforcement" section makes no mention of those potential remedies, those remedies are not inconsistent with the listed remedy of being placed on a Probationary Watch List and being considered for non-renewal. As a result, under the *Perdue*, *Badie*, and *Nantucket Island* rationales, any advisor/manager that entered a CalPERS contract after August 15, 2005, would reasonably expect that CalPERS could impose severe sanctions for RCP non-compliance. Thus, CalPERS is likely free to unilaterally and broadly define what "other action" would result from RCP non-compliance, as long as CalPERS confined such "other action" to contract – not punitive – penalties.

CalPERS should note however that although the RCP defines advisor/manager reporting, notice, and bidding requirements with some particularity, the current RCP likely does not define the term Responsible Contractor or identify what constitutes substantive RCP compliance with sufficient particularity to impose "contract breach" penalties. For example, under the RCP, CalPERS might have an issue imposing breach of contract penalties against an advisor/manager for not using enough RCs on local projects because the RCP does not specify compliance metrics. Indeed, the RCP provides that "practices and labor market conditions vary across the country and that flexibility in [RCP] implementation is very important." [Part VI.J.] Likewise, CalPERS would likely have an issue imposing breach of contract damages against an advisor/manager for using local contractors that inappropriately self-identify as RCs where the

[2] We understand that some advisor/manager contracts contain choice of law provisions referencing Delaware law.

RCP itself states that what constitutes a RC is wholly dependent on numerous local variables. [Part III.]

Accordingly, CalPERS ability to impose contract penalties for non-ministerial RCP violations may be constrained as it is well-settled that where the intention of the parties on "material particulars cannot be ascertained," the contract term is void and unenforceable. *See California Lettuce Growers, Inc. v. Union Sugar Co.*, 45 Cal. 2d 474, 790 (1955); *see also Ladas v. California State Auto. Ass'n*, 19 Cal. App. 4th 761, 771 (1993) (where Plaintiffs claimed that the defendant-employer breached a contract to "consider" parity with other companies in setting plaintiffs' commission rates, the court held the contract was too uncertain to be enforceable; stating: "An amorphous promise to 'consider' what employees at other companies are earning cannot rise to the level of a contractual duty"); *see also Rochlis v. Walt Disney Co.*, 19 Cal. App. 4th 201, 213-14 (1993), disapproved on other grounds by *Turner v. Anheuser-Busch, Inc.*, 7 Cal. 4th 1238, 1251 (1994) (holding that an alleged contractual commitment to pay salary increases or bonuses "appropriate" for plaintiff's responsibilities and performance was not sufficiently certain to be enforceable).

Further, any attempt by CalPERS to impose breach of contract damages against an advisor/manager without a sufficient contractual basis, might lead to a breach of contract counterclaim. Although a public entity, CalPERS is <u>not</u> immune from liability for breach of contract. *See* Cal. Gov. Code § 814 ("Nothing in this part affects liability based on contract or the right to obtain relief other than money or damages against a public entity or public employee.").

**3. CalPERS Likely Cannot Impose Non-Compliance Penalties On Pre-August 2005 Advisor/Manager Contracts.**

a. <u>The 1998 RCP Remedy Language Is Limited And Prospective</u>.

In contrast to the broad RCP "monitoring" language, the 1998 RCP "remedies" language is quite narrow and likely does not cover the addition of contractual remedies for non-compliance. As noted, the only remedy in the 1998 RCP relates to possible non-renewal of future contracts. Nothing in that language would put an existing advisor/manager on notice that CalPERS might unilaterally impose penalties under the existing contract, such as denying follow-on funds or terminating the contract. *See, e.g., Albury v. Plumbers Local Union No. 519*, 100 So.2d 647, 648-49 (Fla. App. 1958) (holding that a subcontractor could establish contract damages against a general contractor if the general contractor decided to force the subcontractor "to use only union employees on the *remainder of his contract* or suffer cancellation of said contract") (emphasis added).

Even if an existing contract provides that the advisor/manager will comply with the *then current* RCP or the RCP *as modified from time to time*, any unilateral change that went so far as to impose previously non-existent contract penalties would likely be deemed unreasonable and inconsistent with principles of good faith and fair dealing. *See, e.g., Badie*, 67 Cal. App. 4th at 795 (noting that California law does not allow a party with contractual discretion to vary terms to "add a radically new and unanticipated term" or seek "to add an entirely new *kind* of term to the original account agreements") (emphasis in original).

The *Nantucket Island* litigation further illustrates the principle in a conceptually analogous situation. There, the General Partner offered its Limited Partners the opportunity to purchase "preferred units" in the limited partnership. 810 A.2d at 357-58. The existing LPs declined, and the GP sold the units to new investors. *Id.* To entice the new investors, the GP unilaterally amended the existing partnership agreement to subordinate the rights of the original LPs to the new investors. *Id.* The LPs sued, and the GP defended, pointing to its contractual right under the partnership agreement to sell "additional limited partnership interests *on such terms and conditions and having such rights and obligations as the Managing General Partner shall determine*." *Id.* at 362 (emphasis added). In essence, the GP argued that it had the contractual discretion to modify the agreement as it saw fit.

The court rejected "whatever surface appeal the defendants' argument has" given the factual and legal context. *Id.* at 362. The court said that although Delaware law "permits a limited partnership agreement to invest far-ranging authority in a general partner," the law "also requires a clear and unambiguous articulation of that authority so that investors are given fair warning of the deal they are making." *Id.* at 355. Although the GP had the "freedom to draft a clear and explicit grant of authority to itself to amend the partnership agreement" to subordinate the original limited partners to subsequent investors, "the general partner did not do so." *Id.* The court held that under those circumstances, the "better reading of the agreement as a whole is that the limited partners were required to assent to any amendment that affected their substantial rights" – which in this case involved their right of return on their investment. *Id.* The court said that because the contract was ambiguous, the ambiguity "must be resolved in a way that vindicates the reasonable expectations of the investors." *Id.; accord Badie*, 67 Cal. App. 4th at 796 (holding that a party breaches the good faith covenant "when the discretionary power is used to recapture opportunities foregone when the contract was entered into").

Here, we assume that CalPERS' pre-August 2005 advisor/manager contracts did not expressly reserve to CalPERS the right to prospectively impose contract penalties for RCP non-compliance, a right CalPERS could have demanded at contract inception. Assuming that to be true, then even a contract provision that requires RCP compliance with the "then existing" RCP, or a RCP as modified from "time to time," would not grant clear and explicit authority under the *Nantucket Island* and *Badie* rationale for CalPERS to impose penalties that would likely be outside "the reasonable expectations of the investors." That conclusion is particularly pertinent here where the 2005 RCP version contains some potential coverage ambiguity, stating on the one hand that it "supersedes" prior RCP policies, but on the other hand might be interpreted to apply only prospectively to "all contracts entered into *after* the effective date of this Policy . . . ."

b. <u>The Imposition Of Contract Penalties For RCP Non-Compliance With Pre-August 2005 Contracts Might Give Rise To Third-Party Tort Claims</u>.

If CalPERS were to unilaterally impose new contract penalties for RCP non-compliance with pre-August 2005 contracts, one could imagine a scenario where – given the importance of the CalPERS relationship – advisors and property managers might accept the contract changes without legal challenge. However, any such unilateral change would likely impact third-party contractors and sub-contractors who would have an incentive to challenge the change. For example, where CalPERS has a contract with Advisor A and Advisor A's property management company, A-prime, to buy, maintain, and lease commercial real estate, A-prime must negotiate



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numerous contracts with local contractors and subcontractors to perform under its contract with CalPERS. If mid-contract, CalPERS unilaterally imposes strict RCP compliance metrics and imposes severe contract penalties for non-compliance, A-prime might intentionally breach and terminate its existing contractor and sub-contractor agreements if those relationships would jeopardize A-prime's ability to meet the RCP metric requirements. From A-prime's perspective, the reward of staying in CalPERS' "good graces" might far outweigh any contractual liability to a local contractor or sub-contractor. However, the aggrieved contractor or sub-contractor might well have a claim against CalPERS for intentional interference with contract or prospective business relations. *See, e.g., Quelimane Co., Inc. v. Stewart Title Guaranty Co.*, 19 Cal. 4th 26, 56-7 (1998) (holding that landowners and buyers stated a claim for intentional interference with existing contractual relations against title insurers who refused to issue title insurance without a quiet title action even though defendants knew such action was not needed; by alleging a contract between plaintiffs, defendants' knowledge of the contract, disruption of the contract, defendants' plan to deny title insurance, and damages, plaintiffs stated all claim elements; plaintiffs were not required to allege that defendants' refusal to issue title insurance was wrongful, because wrongfulness "independent of the inducement to breach the contract is not an element of the tort of intentional interference with *existing* contractual relations") (emphasis original); *Della Penna v. Toyota Motor Sales, U.S.A. Inc.*, 11 Cal. 4th 376, 392 (1995) ("Courts provide a damage remedy against third-party conduct intended to disrupt an existing contract precisely because the exchange of promises resulting in such a formally cemented economic relationship is deemed worthy of protection from interference by a stranger to the agreement.").

"Intentional interference" claims are "tort" claims, which means that CalPERS could be liable not only for contract lost-profit damages, but also for other compensatory damages, as well as punitive damages. *See, e.g., Ramona Manor Convalescent Hosp. v. Care Enter.*, 225 Cal. Rptr. 120, 132 (Ct. App. 1986) (affirming lost profits, compensatory, and punitive damage awards for intentional interference with contractual relations and intentional interference with prospective economic advantage).

Consequently, CalPERS must carefully consider any unilateral action affecting its existing pre-August 2005 advisor/manager contracts that might cause those entities to terminate or breach local contracts.[3]

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[3] CalPERS, the legal entity, is likely immune from tort claims. *See* Cal. Gov. Code § 815(a) (except as otherwise provided by statute, a public entity "is not liable for an injury, whether such injury arises out of an act or omission of the public entity or a public employee or any other person"). However, CalPERS would likely be vicariously liable for the actions of its employees, officers, and agents. *See* Cal. Gov. Code § 815.2(a) (stating that a public entity "is liable for injury proximately caused by an act or omission of an employee of the public entity acting within the scope of his or her employment if the act or omission would, apart from this section, have given rise to a cause of action against that employee or his personal representative); *see also* Cal. Gov. Code § 815.4 (stating that a public entity "is liable for injury proximately caused by a tortious act or omission of an independent contractor of the public entity to the same extent that the public entity would be subject to such liability if it were a private person").

### 4. CalPERS Can Negotiate An Entirely New RCP Program For New Advisor/Manager Contracts.

CalPERS can obviously negotiate a "new" RCP with its advisors and property managers when negotiating new (or renewed) advisor/manager contracts. In a new RCP, CalPERS would be free to ask its investment advisors and property managers to agree to meet strict RCP metrics, impose a formal grievance filing and investigation process, and mandate strict contractual penalties for non-compliance. Such negotiations would of course be subject to CalPERS' shareholder fiduciary duty obligations and would have to be undertaken in good faith. For example, if CalPERS used its negotiating power to influence a potential advisor or property manager to agree to new RCP terms that would effectively force the advisor or property manager to cease doing business with a particular local contractor, the affected local contractor might have a claim against CalPERS for tortious interference with contract or prospective business relations. *See, e.g., Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134, 1164-66 (2003) (allowing intentional interference with prospective economic advantage claim to proceed where losing bidder for a government contract alleged that the winning bidder used improper influence (bribes and sexual favors) to effect the contracting decision).

Absent such hard-to-imagine circumstances, CalPERS is free to implement new RCP enforcement provisions in new contracts that meet the basic offer, acceptance, and consideration requirements for contract formation.

## II. WHAT LEGAL PRINCPLES MIGHT AFFECT POTENTIAL CHANGES TO THE RCP NEUTRALITY PROVISION?

CalPERS desires that its contracting advisors and property managers remain "neutral" in response to legitimate attempts by labor organizations to organize workers on CalPERS owned property. Relevant to that issue is the RCP "Neutrality" section, which states: "Neutrality - CalPERS supports a position of neutrality in the event there is a legitimate attempt by a labor organization to organize workers employed in the construction, maintenance, operation, and services at a System owned property." But what does "neutrality" mean? What neutrality obligations do existing advisor/manager contracts impose? Can CalPERS require its advisors and property managers to remain neutral (whatever that means) under existing contracts and the RCP? If not, can those contracts be modified mid-term to require to-be-defined neutrality? Can CalPERS require neutrality in future contracts? Do CalPERS and its advisors/managers face other legal or reputational risks associated with local organizing activities? Under new or mutually renegotiated neutrality terms, what can CalPERS and its advisors/managers lawfully do to facilitate organizing efforts and still remain "neutral"? What can they clearly not do? How do the recent Presidential and Congressional elections affect the analysis? We address those questions in turn.

### A. <u>What Does "Neutrality" Mean In The Organizing Context?</u>

"Neutrality" during an organizing campaign generally means that the employer will not campaign with employees against the union. However, that concept can be interpreted and applied in many, many different ways depending on the particular circumstances and particular agreement between the employer and the union. For example, a "neutrality" agreement could prohibit an employer from communicating negative "characterizations" or "opinions" about the

union to employees, but allow the employer to provide objective, fact-based information. On the other hand, a neutrality agreement could prohibit the employer from saying *anything* about unions in general or the organizing union in particular. Neutrality agreements can include provisions for union access to on-site employees, unit definitions, and dispute resolution procedures. Neutrality agreements can even set specific time lines for union organizing efforts and restrict a union from engaging in organizing efforts at other employer sites. The variations are numerous and are always tailored to the local conditions. If the employer and the union enter into a formal neutrality agreement, it is a binding and enforceable contract.[4]

Unions usually ask for a neutrality agreement during an organizing campaign in conjunction with a "card check" agreement. In a traditional organizing campaign, a union identifies a group of employees it would like to represent. It then attempts to get those employees to sign "union authorization cards" evidencing the employees' desire to have the union represent them in collective bargaining. If the union gets 30% of the desired unit to sign cards, it can petition the National Labor Relations Board to hold a secret ballot election. As an alternative – and much more successful technique for organizing employees – a union can ask the employer to voluntarily recognize the union if the union provides evidence that a majority of unit employees desire representation. Such evidence usually takes the form of the aforementioned signed authorization cards. If the employer agrees to such a "card check" arrangement as part of its neutrality stance, the union bypasses the secret ballot election process. Unions that obtain neutrality and card check agreements from targeted employers have very high organizing success rates.

### B. Can CalPERS Require Its Advisors/Managers To Remain Neutral During An Organizing Campaign?

#### 1. Under The Current RCP, CalPERS May Not Be Able To Require Neutrality During An Organizing Campaign.

Under the National Labor Relations Act, a private employer does not commit an unfair labor practice by presenting its views on unionization to employees during an organizing campaign as long as it does so in a non-coercive manner. *See* 29 U.S.C. § 158(c). Courts have held that Section 8(c) gives employers a "free speech" right to communicate with employees

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[4] *See, e.g., International Union v. Dana Corp.*, 278 F.3d 548, 558 (6th Cir. 2002) ("[A]n employer's voluntary agreement to silence itself during union organizing campaigns does not violate federal labor policy."); *Hotel Employees Union, Local 2 v. Marriott Corp.*, 961 F.2d 1464, 1470 (9th Cir. 1992) ("Nothing in the relevant statutes or NLRB decisions suggests employers may not agree to remain silent during a union's organizational campaign – something the employer is certainly free to do in the absence of such an agreement."); *see also AK Steel Corp. v. United Steelworkers,* 163 F.3d 403, 406 (6th Cir. 1998) (agreement preventing an employer from "demean[ing] the Union as an organization or its representatives as individuals" and interpretation preventing anti-union communication by employer upheld); *Hotel & Rest. Employees Union Local 217 v. J.P. Morgan Hotel,* 996 F.2d 561, 563 (2nd Cir. 1993) (agreement preventing an employer from interfering with union organizing effort or mounting a campaign with its employees opposing the union upheld).

during organizing campaigns. *Chamber of Commerce v. Brown*, 128 S.Ct. 2408, 2416 (June 19, 2008) (noting: (1) that the California statute at issue "put considerable pressure on an employer to forgo his '*free speech right* to communicate his views to his employees' or else to refuse the receipt of any state funds"; and (2) "The explicit direction from Congress [stated in § 8(c)] to leave noncoercive speech unregulated makes this case easier.") (citations omitted) (emphasis added); *Ass'n of New York State, Inc. v. Pataki*, 471 F.3d 87, 99-100 (2nd Cir. 2006); *accord Steam Press Holdings, Inc. v. Hawaii Teamsters*, 302 F.3d 998, 1009 (9th Cir. 2002) ("Collective bargaining will not work, nor will labor disputes be susceptible to resolution, unless both labor and management are able to exercise their right to engage in 'uninhibited, robust, and wide-open' debate.") (citation omitted). Consequently, a contractual agreement to refrain from exercising Section 8(c) speech rights would likely need to be "clear and unmistakable" to constitute a waiver of such rights. *Metropolitan Edison Co. v. N.L.R.B.*, 460 U.S. 693, 707-08 (1983); *International Broth. Of Teamsters v. Southwest Airlines Co.*, 875 F.2d 1129, 1135 (5th Cir. 1989) ("In general, the contractual waiver of a statutory right under federal labor law must be clear and unmistakably expressed."); *see also NL Industries, Inc. v. NLRB*, 536 F.2d 786, 788-89 (8th Cir. 1976); *Pepsi-Cola Distributing Co.*, 241 NLRB 869 (1979).

It appears that the current RCP does not contain a "clear and unmistakable" contract requirement that advisors/managers remain neutral during organizing campaigns. Rather, the RCP simply expresses CalPERS' "support" for "a position of neutrality." Indeed, the RCP does not attempt to define the "neutrality" term. Likewise, we understand that CalPERS' advisor/manager agreements do not impose a clear and unmistakable waiver of Section 8(c) rights, but simply incorporate the RCP by reference and require that the advisors/managers comply "with CalPERS' objectives and then-current policies regarding the selection of responsible contractors" without stating in the contract that the selection of responsible contractors has anything to do with organizing neutrality (a logically and factually distinct concept). On their face, neither the RCP "support" language nor the advisor/manager contract "selection" language seem to clearly and unmistakably obligate advisors/managers or selected responsible contractors to remain neutral during an organizing campaign. *Cf. Delaware Coca-Cola Bottling Co. v. General Teamsters Local 326*, 624 F.2d 1182, 1187-88 (3d Cir. 1980) (holding that a single, broad, generally-worded no-strike clause does not constitute a clear and unmistakable waiver of the right of employees to engage in a sympathy strike). As a result, CalPERS likely cannot require its advisors/managers to remain neutral during organizing campaigns under existing contracts.

Additionally, for the same reasons that CalPERS likely cannot impose new RCP non-compliance penalties under contract language referring to the "then current" or "modified from time to time" RCP (*see* Part I.D.2. above), CalPERS likely cannot impose new (and previously non-existent) neutrality requirements or non-compliance penalties on existing advisor/manager contracts.

**2. CalPERS Is Free To Require Campaign Neutrality In Future Advisor/Manager Agreements.**

As noted above, an employer may waive its Section 8(c) free speech rights. It can do so in a neutrality agreement negotiated directly with a union. It can also do so as part of a "project labor agreement" with a general contractor or property owner. *See, e.g., Building and Const.*

*Trades Council of Metropolitan Dist. v. Associated Builders and Contractors of Massachusetts /Rhode Island, Inc. (Boston Harbor)*, 507 U.S. 218 (1993).

Thus, there is no legal impediment to CalPERS requiring its advisors/managers to remain neutral in organizing campaigns to be eligible for *new, future* agreements. Additionally, CalPERS could consider renegotiating existing agreements to incorporate specifically defined neutrality requirements and penalties for non-compliance.

Although we conclude that CalPERS may require advisors/managers to remain neutral during organizing campaigns as a pre-condition for future business deals, CalPERS should be aware that its status as a political subdivision of the State of California could create serious legal issues if it attempts to *regulate* advisor, manager, or contractor conduct on labor or neutrality issues outside the four corners of its own contracts. Any attempt by CalPERS to require its advisors, managers, or contractors to remain neutral in organizing campaigns at properties other than those covered by a CalPERS contract would likely cause advisors, managers, and their counsel – in the first instance – to challenge CalPERS' right to demand such agreements. However, we believe that with adequate explanation of the legal considerations described below, advisors/managers will understand CalPERS' rights and limitations in this area. Those legal considerations are as follows.[5]

a. <u>CalPERS Is A State Actor</u>.

CalPERS is a political subdivision of the State of California because it was created by the state as an administrative arm of state government and is administered by individuals who are responsible to public officials. *Cf. NLRB v. Natural Gas Util. Dist*, 402 U.S. 600, 605 (1971). Because CalPERS is an arm of the state, with the power and authority of a "state" actor, its has the potential to *regulate* private employer activity and is subject to federal labor law that "pre-empts" certain state regulatory activity in the labor relations arena. The idea is that Congress intended for the National Labor Relations Act and the National Labor Relations Board to uniformly regulate (or not) labor policy throughout the United States and that states should not interfere with that uniform scheme through local regulation.

The United States Supreme Court has developed three legal principles that control state regulatory activity in the labor relations arena: (1) *Garmon* pre-emption for state regulation that implicates the protections and proscriptions of the National Labor Relations Act; (2) *Machinist* pre-emption for state regulation that implicates labor relations subjects (such as the use of economic pressure in labor disputes) that Congress intended to leave unregulated; and (3) the "market participant" exception to *Garmon* and *Machinist* pre-emption. As discussed below, CalPERS is not "pre-empted" from requiring neutrality in future advisor/manager agreements because it qualifies as a "market participant," even though it is a "state" actor as a political subdivision of California. That conclusion is buttressed by the United States Supreme Court's *Boston Harbor* decision. There, the Court found that a state actor could require all private

[5] CalPERS should seek separate counsel on whether its ability to demand neutrality from advisors/managers as a pre-condition for future business agreements is consistent with fiduciary duty standards.

contractors who wanted to bid on a Boston harbor development project to sign a "project labor agreement," which essentially required the private contractors to recognize pre-designated unions to represent their employees under pre-defined contract terms. 507 U.S. at 230-33. The Court held that the state entity could require the PLA because it qualified for the "market participant" exception.

b. *Garmon* Pre-emption.

In *Boston Harbor*, the Court noted that "*Garmon* pre-emption" forbids state and local regulation of activities that are "protected by § 7 of the [NLRA], or constitute an unfair labor practice under § 8." 507 U.S. at 224-25 (citing *San Diego Building Trades Council v. Garmon,* 359 U.S. 236 (1959)). The court held that "*Garmon* pre-emption prohibits regulation even of activities that the NLRA only *arguably* protects or prohibits." *Id.* (citing *Wisconsin Dept. of Industry v. Gould Inc.*, 475 U.S. 282, 286 (1986)). The Court explained: "This rule of pre-emption is designed to prevent conflict between, on the one hand, state and local regulation and, on the other, Congress' 'integrated scheme of regulation,' embodied in §§ 7 and 8 of the NLRA, which includes the choice of the NLRB, rather than state or federal courts, as the appropriate body to implement the Act." *Id.*

In *Boston Harbor*, the Court illustrated the *Garmon* pre-emption principle by describing the facts of *Garmon* and *Gould.* The Court noted that in *Garmon* "this Court held that a state court was precluded from awarding damages to employers for economic injuries resulting from peaceful picketing by labor unions that had not been selected by a majority of employees as their bargaining agent" because the NLRA protects peaceful picketing. *Boston Harbor*, 507 U.S. at 225. In *Gould,* the Court noted, "we held that the NLRA pre-empts a statute that disqualifies from doing business with the State persons who have violated the NLRA three times within a 5-year period. We emphasized there that 'the *Garmon* rule prevents States not only from setting forth standards of conduct inconsistent with the substantive requirements of the NLRA, but also from providing their own regulatory or judicial remedies for conduct prohibited or arguably prohibited by the Act.'" *Id.*

c. *Machinist* Pre-emption.

The *Boston Harbor* Court then noted that "*Machinists* pre-emption," "prohibits state and municipal regulation of areas that have been left 'to be controlled by the free play of economic forces.'" *Id.* at 225-26 (citing *Golden State Transit Corp. v. Los Angeles,* 475 U.S. 608, 614 (1986) (*Golden State I*)). "*Machinists* pre-emption preserves Congress' 'intentional balance' 'between the uncontrolled power of management and labor to further their respective interests.'" *Id.*

The Court stated: "In *Machinists,* we held that the Wisconsin Employment Relations Commission could not designate as an unfair labor practice under state law a concerted refusal by a union and its members to work overtime, because Congress did not mean such self-help activity to be regulable by the States. We said that it would frustrate Congress' intent to 'sanction state regulation of such economic pressure deemed by the federal Act 'desirabl[y] ... left for the free play of contending economic forces....'" Similarly, the Court noted: "In *Golden State I,* we applied the *Machinists* doctrine to hold that the city of Los Angeles was pre-empted from conditioning renewal of a taxicab operating license upon the settlement of a labor dispute. We reiterated the principle that a 'local government ... lacks the authority to' 'introduce some

standard of properly 'balanced' bargaining power' ... or to define 'what economic sanctions might be permitted negotiating parties in an 'ideal' or 'balanced' state of collective bargaining.'" *Id.*

d. The "Market Participant" Exception.

The *Boston Harbor* Court went on to hold: "When we say that the NLRA pre-empts state law, we mean that the NLRA prevents a State from regulating within a protected zone, whether it be a zone protected and reserved for market freedom, see *Machinists,* or for NLRB jurisdiction, see *Garmon.*" *Id.* at 226-27. "A State does not regulate, however, simply by acting within one of these protected areas. When a State *owns and manages property*, for example, it must interact with private participants in the marketplace. In so doing, the State is not subject to pre-emption by the NLRA, because pre-emption doctrines apply only to state *regulation.* Our decisions in this area support the distinction between government as regulator and government as proprietor." *Id.* (emphasis added).

The Court particularly distinguished the conduct at issue by the State of Wisconsin in *Gould* to illustrate the difference between the state as a regulator and the state as a market participant. There, the Court held that "the conduct at issue was a state agency's attempt to compel conformity with the NLRA. Because the statute at issue in *Gould* addressed employer conduct *unrelated to the employer's performance of contractual obligations to the State,* and because the State's reason for such conduct was to deter NLRA violations, we concluded: *'Wisconsin simply is not functioning as a private purchaser of services,'* ... [and therefore,] for all practical purposes, Wisconsin's debarment scheme is tantamount to regulation. We emphasized that we were 'not say[ing] that state purchasing decisions may never be influenced by labor considerations.'" *Id.* The Court held: "Permitting the States to participate freely in the marketplace is . . . consistent with NLRA pre-emption principles . . . ." and, "[i]n the absence of any express or implied indication by Congress that a State may not *manage its own property* when it pursues its purely proprietary interests, and where analogous private conduct would be permitted, this Court will not infer such a restriction." *Id.* at 230-31 (emphasis added). The Court went on to note that "when the [state agency], acting in the role of purchaser of construction services, acts just like a private contractor would act, and conditions its purchasing upon the very sort of labor agreement that Congress explicitly authorized and expected frequently to find, it does not 'regulate' the workings of the market forces that Congress expected to find; it exemplifies them." *Id.* at 232-33.

e. When CalPERS Buys Commercial Real Estate As An Investor, It Acts As A Market Participant.

The foregoing authority demonstrates that CalPERS is a market participant when it buys commercial real estate as an investor, as long as it does not attempt to control advisors/managers' "conduct unrelated to the employer's performance of contractual obligations to the [System]." In its "investor" capacity, CalPERS functions in the same manner as any private investor would. Notably, CalPERS invests in projects around the country, outside of California, where it has no arguable "regulatory" authority. Likewise, CalPERS' RCP does not seek to control advisor/manager conduct outside of the specific project/investment that is the subject of the advisor/manager agreement. Therefore, CalPERS' investment projects and the related advisor/manager agreements are controlled by the Supreme Court's *Boston Harbor* decision, and CalPERS is free to require neutrality agreements in future business deals.

f. State Action Designed To Require Neutrality During Campaigns.

CalPERS should note for informational purposes that two states, California and New York, have enacted legislation requiring "state contractors" to remain "neutral" during organizing campaigns. In both situations, private employers challenged the legislation, arguing among other things that the employers' Section 8(c) free speech rights pre-empted the legislation. In the California case, the Ninth Circuit Court of Appeals ruled that the NLRA did not preempt the state legislation even though it was regulatory in nature because – according to the Ninth Circuit – the legislation did not fall within the specific proscriptions of either *Machinist* (unregulated activity) or *Garmon* (prohibited or protected activity). *Chamber of Commerce v. Lockyer*, 463 F.3d 1076, 1079 (9th Cir. 2006) (en banc). In the New York case, the Second Circuit Court of Appeals reached a somewhat different conclusion and found that the neutrality regulation was pre-empted to the extent it regulated organizing activity beyond that which is a "direct cost" to the State. *Healthcare Ass'n of New York State, Inc. v. Pataki*, 471 F.3d 87, 99-100 (2nd Cir. 2006) ("[A] State cannot leverage its money to affect the contractor's protected activity beyond the contractor's dealings with the State.") (citing *Northern Ill. Chapter of Associated Builders & Contractors, Inc. v. Lavin*, 431 F.3d 1004, 1006 (7th Cir. 2005) ("Conditions on spending may become regulation if they affect conduct other than the financed project.").

The United States Supreme Court accepted the employers' appeal of the Ninth Circuit's *Lockyer* decision and reversed. *Chamber of Commerce v. Brown*, 128 S.Ct. 2408 (June 19, 2008). The Supreme Court noted that Section 8(c) manifests Congress' intent to encourage free debate on labor relations issues, and that California's law attempted to limit that debate as a matter of state-wide regulation. *Id.* Consequently, the Court struck down the California statute. Here, CalPERS does not attempt to influence neutrality decisions outside the four corners of its own contracts. Accordingly, the Supreme Court's *Chamber of Commerce* decision does not impact CalPERS' actions as long as those actions fall squarely within the market-participant exception described above.

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***MEMORANDUM***

date: November 7, 2008

to: CalPERS Board of Administration

from: Ethan Lipsig and Stephen Harris
Telephone Number: (213) 683-6304

subject: Fiduciary Considerations in Connection with RCP Reconsideration

file no.: 38836.00002

The CalPERS Board of Administration ("Board") has informed us that it is in the process of reconsidering the CalPERS Responsible Contractor Policy (the "RCP"). The Board has asked us to comment on its fiduciary obligations with respect to such reconsideration.

As the Board is well aware, it has two primary fiduciary duties: loyalty and prudence. Cal. Const. Art. XVI, Sections 17(b) and 17(c).

Under its duty of loyalty, the Board must act solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions to the system and defraying reasonable expenses of administering the system. The duty to CalPERS' participants and beneficiaries takes precedence over any other duty.

The duty of prudence that Section 17(c) imposes requires the Board to discharge its duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

Under generally accepted interpretations of virtually identical statutes, this imposes a <u>procedural</u> prudence requirement. This duty is satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties, and (B) has acted accordingly. 29 C.F.R. § 2550.404a-1 (interpreting the prudence requirement applicable to private benefit plan fiduciaries).

These duties generally limit the extent to which the Board may take actions that are not directly related to its "Program Goals" of providing benefits or optimizing investment performance. While it is unclear – given CalPERS' unique status and history of activism – just how far the duties of loyalty and prudence would permit the Board to take actions to subordinate Program Goals to other goals, the Board likely would breach its duty of loyalty if it does subordinate Program Goals to other goals in material ways, especially if its actions increase CalPERS' costs or harm investment performance.

In considering whether to adopt changes to the RCP, the Board should consider whether doing so would positively or adversely affect:

- CalPERS' investment opportunities;
- overall investment performance (*e.g.*, by pressuring partners to make sensible or inappropriate employment-related decisions resulting in lower or higher labor and maintenance costs);
- administrative expenses (*e.g.*, by reducing or increasing the cost of administering the RCP in any appreciable manner);
- effective utilization of CalPERS' resources (*e.g.*, management resources); or
- potential CalPERS liability under applicable law (*e.g.*, federal labor law).

In addition, we believe that the Board should consider whether any changes to the RCP are necessary at the present time in light of likely changes in federal labor law that could impact union organization efforts, one way or another.

Accordingly, if the Board reasonably concludes (after giving appropriate consideration to all relevant factors) that changing the RCP would enhance (or not adversely affect) CalPERS' investment performance and would not result in too great of an expense or result in other detriments, adopting the change should be consistent with its fiduciary duties.

Even after the Board decides whether to adopt a revised RCP, the Board must continue to monitor the RCP and, if necessary, modify it so that it remains sound and appropriate in operation.