

ATTACHMENT B

STAFF'S ARGUMENT

STAFF'S ARGUMENT TO ADOPT THE PROPOSED DECISION ON REMAND

INTRODUCTION

Previously, this Board found that Respondent Bruce Malkenhorst, Sr. ("Malkenhorst"), together with his employer—Respondent City of Vernon ("City")—"subvert[ed] the transparency requirements of the PERL" by obfuscating the pay Malkenhorst received for his concurrent work in multiple positions and causing him to retire with benefits that were grossly inflated beyond what the law allows. Based on these findings, CalPERS recalculated Malkenhorst's payrate—a core component of the CalPERS retirement benefit—and that recalculation is the subject of a third Proposed Decision ("PD") (entitled Proposed Decision on Remand) which is now before the Board. The PD affirms the reduction of Malkenhorst's monthly payrate from \$35,302 to \$14,020 and permits CalPERS to recoup ten years' worth of overpayments, which Malkenhorst received because of his improperly inflated payrate. CalPERS staff agrees with the Proposed Decision on Remand.

FACTUAL BACKGROUND

The City contracts with CalPERS for retirement benefits for its eligible employees. The California Public Employees' Retirement Law, or PERL, governs the City's contract with CalPERS, and establishes the terms and conditions by which CalPERS pays retirement benefits to retired employees.

Malkenhorst first joined the City in 1975 as its Deputy City Clerk/Deputy Director of Finance. He became City Administrator/City Clerk and City Treasurer in 1978. Over the years, Malkenhorst's job titles and duties changed. While remaining as City Administrator, City Clerk and City Treasurer, Malkenhorst added the titles of Director of Finance and Personnel, Executive Director of Light and Power, Chief Executive Officer (CEO) of the Electrical Department, Executive Director of the Redevelopment Agency, Secretary of the Redevelopment Agency, CEO of the Gas Municipal Utility Department, Executive Director of the Industrial Development Authority, Secretary of the Industrial Development Authority, Treasurer of the Industrial Development Authority, and Executive Director of the Vernon Historic Preservation Society.

When CalPERS learned of Malkenhorst's multiple positions, it advised the City that each position needed a separate payrate, and that the City needed to track the percentage of Malkenhorst's time spent in each position. Neither the City nor Malkenhorst complied.

Instead of publishing separate payrates for each of Malkenhorst's positions, the City substantially increased the published payrate for Malkenhorst's City Administrator/City Clerk position. The payrate increases far surpassed expected norms. For example, in

1980, the payrate for City Administrator/City Clerk was \$4,547 per month. In 2005, at Malkenhorst's retirement, his City Administrator/City Clerk payrate was \$35,302 per month. By comparison, the final payrate would have been only \$13,370.03 had Malkenhorst received average merit and cost of living increases that are used by CalPERS' actuaries to estimate potential salary increases across all employers who participate in the retirement system.

PROCEDURAL BACKGROUND

CalPERS did not discover Malkenhorst's improper payrate until 2011-2012, when it audited the City's payroll and retirement records. In October 2012, CalPERS issued a determination letter advising Malkenhorst that his payrate would be reduced from \$35,302 per month to \$7,875, the payrate for Acting City Clerk adopted by the City after Malkenhorst retired. Malkenhorst appealed the determination of his payrate, and a hearing was held before an Administrative Law Judge (ALJ) with the Office of Administrative Hearings (OAH) over a period of six days between August 2014 and February 2015.

The ALJ issued a PD finding that Malkenhorst's \$35,302 payrate did not comply with the PERL. The City had "successfully concealed from public view any connection between respondent Malkenhorst's payrate increases and the new job titles and responsibilities assigned to him, making it impossible ... to ascertain what the payrate was for each of those positions." (Proposed Decision, In the Matter of the Calculation of Final Compensation of Bruce Malkenhorst, Sr., and City of Vernon, dated July 14, 2015.)

Although Malkenhorst's payrate would need to be redetermined, the ALJ found that the payrate (\$7,875) used by CalPERS—that of the Acting City Clerk—was inadequate. That payrate did not reflect the fact that Malkenhorst had other duties in addition to his clerking responsibilities.

On December 16, 2015, following a hearing before the entire CalPERS Board of Administration, the Board rejected the PD and issued its own Final Decision. The Final Decision adopted the Acting City Clerk payrate as Malkenhorst's payrate, and found that the difference resulted in overpayments that CalPERS could recover through reduction of Malkenhorst's future retirement benefit payments.

Malkenhorst challenged the Final Decision by filing a petition for writ of administrative mandate in Los Angeles County Superior Court. On December 6, 2015, the Superior Court issued a tentative decision granting the petition in part and denying it in part. The Court agreed that Malkenhorst's payrate must be reduced. However, the Court rejected CalPERS' decision to use the Acting City Clerk payrate (\$7,875) because, among other reasons, Malkenhorst's overall duties "greatly exceeded" the duties of that position. The Court also held that CalPERS could recoup overpayments, but that it must provide Malkenhorst with an opportunity to challenge the recoupment on statute of limitations grounds.

CalPERS addressed the Court's tentative decision by calculating a new payrate for Malkenhorst using a methodology previously applied to another City manager. This new methodology computed an average payrate for all "director" positions at the time of Malkenhorst's retirement. The result was a payrate of \$14,020.

CalPERS advised Malkenhorst that his payrate would be \$14,020 and that CalPERS intended to recoup overpayments based on the ten-year statute of limitations applicable to "fraudulent reports of compensation." The overpayments totaled approximately \$1.97 million.

By letter dated July 24, 2017, Malkenhorst appealed this determination. A second administrative hearing was held on September 17, 2018. The issues presented to the ALJ were: (1) Whether CalPERS properly re-determined Malkenhorst's payrate to be \$14,020; and (2) Whether CalPERS could apply the ten-year statute of limitations, pursuant to Government Code section 20164(d)&(e) based on "fraudulent reports of compensation."

In its February 11, 2019 proposed decision, the ALJ agreed that CalPERS could recoup overpayments based on the ten-year statute of limitations. But the ALJ also found that CalPERS had failed to show a \$14,020 payrate was reasonable—that showing would require CalPERS to "consider prior and subsequent salary schedules regarding the City Administrator position, Malkenhorst's salary history, or projected cost-of-living and merit-based pay increases." (PD at p. 7, ¶ 22.)

At the request of the Board, a third administrative hearing took place on November 12, 2019, for CalPERS to provide the additional showing sought by the ALJ. CalPERS explained through testimony, documents, and briefing that: 1) CalPERS could not rely upon the salary schedules for a full-time City Administrator because, at the City, the position of City Administrator was only part-time; and 2) the addition of cost-of-living and merit-pay increases to Malkenhorst's historical payrate would result in a retirement payrate of \$13,370.03 per month, less than the \$14,020 payrate offered by CalPERS.

LEGAL ISSUES

This case involves essentially two legal issues: (1) the proper calculation of Malkenhorst's payrate; and (2) whether CalPERS can recoup 10 years' worth of overpayments based on Malkenhorst's fraudulent conduct in hiding them. Staff argues the Board adopt the PD on both issues.

Under the PERL, a service retiree's benefit is based on three factors: the retiree's credited years of service, final compensation, and age at retirement. (*Prentice v. Board of Administration* (2007) 57 Cal.App.4th 983, 989.) Final compensation is a function of Malkenhorst's highest "compensation earnable" (*Prentice*, 57 Cal.App.4th at p. 989), and

compensation earnable consists of a member's "payrate" and "special compensation." (*Molina v. Board of Admin.*, California Public Employees' Retirement System (2011) 200 Cal.App.4th 53, 66.) Payrate – the issue here – is "the monthly rate of pay or base pay of the member, paid in cash and pursuant to publicly available pay schedules, for services rendered on a full-time basis during normal working hours...." (Gov. Code § 20636(b)(1).)

Salary provided to a public employee is not part of payrate if it hasn't been adequately disclosed in a "publicly available pay schedule." (*Prentice*, 57 Cal.App.4th at pp. 994-996.) A pay schedule is proper only if it "[i]dentifies the position title for every employee position" and "[s]hows the payrate for each identified position...." (2 Cal. Code Regs. §570.5(a)(2) & (a)(3).) If a rate of pay does not meet these criteria, "the Board, in its sole discretion, may determine an amount that will be considered to be payrate, taking into consideration all information it deems relevant." (2 C.C.R. § 570.5(b).)

Where any payment has been made by CalPERS "as a result of fraudulent reports of compensation made, or caused to be made, by a member for his or her own benefit," CalPERS has the authority to recover such erroneous payments made, up to a period of ten years. (Gov. Code § 20164(d).) The ten-year limitation period accrues "either from the date of payment or upon discovery of the fraudulent reporting, whichever date is later." (Id.) The PERL does not address tolling principles for either limitations period, except to say that CalPERS' "determination with respect to the running of any period of limitation shall be conclusive and binding" (Gov. Code § 20164(e).)

At the hearing, CalPERS presented evidence that it derived Malkenhorst's payrate by averaging the five payrates for the City's directors as set forth in the City's July 1, 2005 pay schedule. The positions, and corresponding monthly payrates, were as follows: Director of Community Services and Water (\$12,974), Acting Director of Light and Power (\$24,000), Fire Chief (10,899), Police Chief (\$11,243), and Director of Environmental Health (\$10,986). The average payrate for these five director positions was \$14,020.

CalPERS decided to use this outcome—\$14,020—for Malkenhorst's payrate because the method was objective, not based purely on self-reporting, and reflected City practices at the time of Malkenhorst's retirement. CalPERS relies on pay schedules for payrate determinations because they are "contemporaneously prepared public records" required by law, and because using publicly disclosed records encourages transparency. CalPERS previously applied this same methodology in a prior Final Decision, In the Matter of the Calculation of Final Compensation of Robert Toering and City of Vernon (June 22, 2015). The Toering decision arose from a CalPERS determination resulting from the same City's audit in 2011-2012 that prompted CalPERS to reject the payroll reported for Malkenhorst. Mr. Toering had served as Director of Industrial Development for the City.

With respect to recovery of erroneous overpayments, CalPERS argued that Malkenhorst committed fraud because he suppressed information about his job titles and salary. CalPERS argued that it had requested this information from Malkenhorst before he retired, and that City's pay schedules in existence prior to Malkenhorst's retirement did not accurately reflect his titles and duties, or the pay associated with each of them. Malkenhorst argued that CalPERS was equitably estopped from recalculating his payrate or recouping any overpayment. He also argued that recoupment was barred by the equitable defense known as laches, arguing CalPERS unreasonably delayed in seeking recoupment during the period 2005-2012. Malkenhorst also argued that his actions were not fraudulent.

THE PROPOSED DECISION ON REMAND

After considering all of the evidence and the parties' arguments, the ALJ denied Malkenhorst's appeal. With respect to payrate, the ALJ ruled that the calculation method chosen by CalPERS "is not arbitrary and yields a payrate [\$14,020] higher than a payrate that would result from looking at merit and cost-of-living increases [\$13,370.03]. There has been no abuse of discretion." The ALJ also credited CalPERS finding that it could not use City Administrator payrates adopted by the City after Malkenhorst's retirement. "CalPERS used information it obtained in its 2012 audit of the City. It found that the three City Administrators who served after Malkenhorst retired, from December 2006 to 2012, worked in that position only part-time, as had Malkenhorst. CalPERS could not calculate a full-time payrate in compliance with the PERL to apply in this case."

With respect to recoupment, the ALJ also agreed with CalPERS. The ALJ found that "[t]he schedules reflected in Vernon City Council resolutions did not accurately reveal Malkenhorst's titles and duties and the pay associated with each of them. Both Vernon and Malkenhorst deliberately participated in obscuring the truth." The ALJ further ruled that "[t]he concealment of accurate details in the pay schedules constitutes intentional suppression of material facts by those with a duty to disclose those facts, leaving the public and CalPERS, which relies on the pay schedules, in ignorance, in contravention of the PERL." For these reasons, the ALJ held that the ten-year statute of limitations applied.

The parties also asked the ALJ to determine the legal issue of whether the ten-year statute of limitations was tolled by Malkenhorst's administrative appeal of CalPERS' 2012 determination. The ALJ found that CalPERS' right to seek recoupment did not accrue until the 2012 audit discovered the "suppression of pertinent information." However, the ALJ found that the statute was not tolled because CalPERS could have sought recoupment in its prior, 2012 Statement of Issues. The ALJ also declined to address CalPERS' argument that not tolling the statute of limitations in fraud cases might require CalPERS to file civil actions against members so as to preserve any collection rights it may have outside of administrative recoupment.

STAFF'S ARGUMENT

CalPERS has exhaustively investigated and litigated Malkenhorst's various factual and legal arguments regarding how his monthly payrate should be calculated. The ALJ has now considered and rejected all of those arguments, reaching a decision that faithfully adheres to the PERL and its policies. The decision also affirms CalPERS' broad discretion to use objective, verifiable data to construct a payrate where the member clearly defies those requirements of the PERL, in an effort to gratuitously spike his pension. In holding that Malkenhorst committed fraud, the PD on Remand also protects CalPERS' ability to exercise the fiduciary duty it owes to all other members by seeking to recover more than \$1 million in overpayments made to Malkenhorst. Adopting the PD on Remand in full will allow staff to reduce Malkenhorst's pension to recover the overpayment, as well as consider other methods of collection. For all of these reasons, staff argues the Board should adopt the PD on Remand in full.

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Kevin M. Kreutz
Staff Attorney