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November 15, 2013

REPORT TO THE RULES AND ECONOMIC DEVELOPMENT COMMITTEE

LEGAL ANALYSIS OF PROPOSED MEMORANDUM OF UNDERSTANDING BETWEEN THE CITY OF SAN DIEGO AND THE CITY EMPLOYEES' RETIREMENT SYSTEM, RELATED TO ADMINISTRATION OF RETIREE HEALTH BENEFITS

## INTRODUCTION

The Rules and Economic Development Committee (Rules Committee or Committee) has requested a legal analysis of the Memorandum of Understanding (MOU) proposed by the San Diego City Employees' Retirement System (SDCERS), acting through its Board (Board) related to their processing of the City of San Diego's (City) retiree health benefits. Specifically, the Committee has requested an analysis of the comparative risk to the City of entering into the MOU (and agreeing to indemnify SDCERS) versus the risk if the City does not approve the MOU. The Committee has asked whether the agreements to indemnify SDCERS and waive the City's right to collect damages against SDCERS for SDCERS' negligence, including gross negligence, violate public policy. Finally, the Committee asked for information regarding SDCERS' inability to incur non-pension expenses from the retirement system's trust fund.

SDCERS, acting through its Board, is the administrator of the City's defined benefit retirement plan (Retirement Plan).[1] Under San Diego Charter (Charter) section 144, the Board has exclusive control over the administration and investment of the retirement trust fund, and is the "sole authority and judge" of who may receive benefits under the Retirement Plan, subject to ordinances adopted by the San Diego City Council (Council). Retiree health benefits are not part of the Retirement Plan. Thus, the Board has no such authority or responsibility regarding the City's retiree health benefits.[2]

The City's Risk Management Department administers the health benefits for both active and retired City employees. Risk Management staff determines the health plans to be offered to employees and retirees, selects the insurance carriers, and negotiates the contracts with the carriers. And while the SDCERS Board makes decisions regarding retirement benefit eligibility, the City is the sole authority and judge on eligibility for retiree health benefits.

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[1] San Diego Charter § 144.

[2] For purposes of this Memorandum, "retiree health benefits" include the post-employment health benefits for eligible employees retiring after March 30, 2012, and the limited retiree health benefit for employees who retired before October 6, 1980.

Even if retiree health benefits were part of the Retirement Plan, which they are not, federal tax law prohibits the use of retirement trust fund assets to pay or administer retiree health benefits, unless the plan meets the requirements of Internal Revenue Code (IRC) section 401(h). Because the Retirement Plan does not meet these requirements, the retiree health benefits cannot be paid from SDCERS trust fund assets. Nor can the costs of administering retiree health benefits, defending lawsuits, or paying judgments arising out of the administration of retiree health benefits be paid from SDCERS trust fund assets.

As a condition of continuing to assist the City to administer retiree health benefits, SDCERS has asked the City to enter into a Memorandum of Understanding (MOU) that includes broad indemnification and limitation of liability provisions. The MOU SDCERS initially proposed included, in the section entitled "Limitation of Liability," a waiver of the City's right to collect damages against SDCERS, "regardless of SDCERS' negligence, even if such damage is caused as a result of SDCERS' gross negligence." SDCERS has since agreed to delete the reference to gross negligence, and the MOU that will return to the Rules and Economic Development Committee (Rules Committee or Committee) for review includes this modification.

## QUESTIONS PRESENTED

1. May SDCERS pay retiree health benefits from retirement system assets, use system assets to administer these benefits, or expose the system's assets to claims related to administering these benefits?

2. Does the MOU'S "Indemnification and Defense" provision violate public policy?

3. Does the MOU's "Limitation of Liability" provision violate public policy?

4. What are the comparative risks to the City of agreeing to indemnify SDCERS versus not agreeing to indemnify SDCERS?

## SHORT ANSWERS

1. No. SDCERS' only assets are held in trust to pay benefits under the Retirement Plan and the reasonable costs of administering those benefits, including the costs of defending and paying claims arising from its administration of the Retirement Plan. The City's retiree health benefits are not benefits under the Retirement Plan. Therefore, SDCERS is prohibited from using retirement trust fund assets to pay (a) retiree health benefits, (b) related administration costs, or (c) the costs of defending against or paying claims arising from administering retiree health benefits.[3]

[3] SDCERS' General Counsel, Elaine Reagan, agrees. A copy of her letter explaining SDCERS' position is attached as Exhibit 1.

2. No. An agreement to indemnify another party against the consequences of a future act violates public policy *only* if it the parties know that the act is unlawful and the agreement encourages or induces the unlawful act. The MOU memorializes the terms under which SDCERS will provide administrative services related to the City's retiree health benefits. The MOU is not intended to induce SDCERS to do an unlawful act. Any unlawful acts committed by SDCERS would be incidental to the MOU, not the intended result of the MOU. Thus, the indemnity provision does not violate public policy.

3. No. The City would not violate public policy by waiving its right to collect damages against SDCERS, even damages arising from SDCERS' acts of gross negligence. But, a release of liability will not generally shield a party from liability arising from acts of gross negligence. SDCERS has removed the reference to "gross negligence" in the MOU. Even if it had not done so, SDCERS probably could not have enforced that provision.

4. The functions SDCERS performs with respect to retiree health benefits are performed by City employees.[4] The City is vicariously liable for the acts of its employees in the scope of their employment, regardless of whether or not the City approves the MOU.

## FACTUAL BACKGROUND

Although the City is the administrator of the retiree health benefits, SDCERS staff historically has performed certain administrative functions related to these benefits, including: (1) enrolling eligible City retirees into the City-sponsored health plans for retirees, (2) processing reimbursement claims for retirees eligible for the City's limited retiree health benefit, (3) conducting the annual health plan open enrollment for City retirees, and (4) transmitting monthly premiums to the City's health insurance carriers on retirees' behalf. These services are performed by *City* employees working at SDCERS. The Board has no role in administering retiree health benefits.

Between 1982 and 2005, SDCERS' trust fund assets were improperly used at various times and to varying degrees to pay retiree health benefits. During many of these years, the City also failed to reimburse SDCERS for staff time and other expenses involved in administering retiree health benefits, resulting in payment of these costs from retirement trust fund assets. These practices violated the Retirement Plan and federal tax laws, and they put the Retirement Plan at risk for disqualification by the Internal Revenue Service (IRS).

Based upon advice of tax counsel, on July 1, 2005, the City began making annual payments to SDCERS to cover the retiree health benefits and related administration expenses. In 2008, the City and SDCERS entered into a settlement with the IRS in which they agreed that SDCERS trust funds would not be used to pay retiree health benefits or related administrative expenses, and that the City would continue paying retiree health benefits and administrative expenses on an annual "pay as you go" basis.[5]

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[4] SDCERS employees are City employees under the Charter and the Municipal Code. See generally, Charter § 117, San Diego Municipal Code § 22.1801.

[5] A copy of the Compliance Statement issued by the IRS, and agreed to by SDCERS and the City, is attached.

SDCERS has requested to memorialize this process in an MOU, to ensure that retirement trust fund assets cannot be used to pay or administer retiree health benefits, and that the trust fund will not be exposed to liability by having SDCERS staff perform functions unrelated to administering the Retirement Plan. The proposed MOU includes the City's agreement to advance sufficient funds to cover all expenses related to SDCERS' processing of retiree health benefits, including staff time, administrative expenses, consultant fees, and defense costs.

The MOU includes a broad indemnity provision, whereby the City would agree to indemnify and defend SDCERS against any "loss, cost, claim, suit, damage, liability or expense" related to SDCERS' performance under the MOU. The MOU also contains a limitation of liability provision, whereby the City (1) acknowledges that "all assets SDCERS holds are held in trust for the benefit of its Members, Beneficiaries and Participants," and (2) waives it right to collect any damages from SDCERS "regardless of SDCERS' negligence." SDCERS has indicated that it will not continue to process retiree health benefits for the City without these broad indemnity and waiver provisions.

## ANALYSIS

### I. RETIREMENT SYSTEM ASSETS CANNOT BE USED TO PAY OR ADMINISTER RETIREE HEALTH BENEFITS.

Charter section 141 grants the Council authority to establish by ordinance a defined benefit plan for City employees. Under this authority, the Council has enacted a series of detailed ordinances (San Diego Municipal Code (Municipal Code) sections 24.0100-24.1905), which define the benefits under the Retirement Plan. These Municipal Code provisions and Charter sections 141-151 comprise the "plan document" for the Retirement Plan.

The Retirement Plan is a qualified governmental plan under IRC sections 401(a) and 414(d). To maintain the Plan's qualified status, and the associated tax advantages, the terms of the plan document and the administration of the plan must comply with IRC section 401(a). Section 401(a) requires, among other things, that employee and employer contributions be made to a trust that is established for the purpose of distributing the trust's principal and income to employees according to the terms of the plan.[6]

A qualified plan must be maintained for the exclusive benefit of plan members or their beneficiaries.[7] It must be impossible under the plan document for any part of the principal or income of the trust to be diverted for any purpose other than those specified in the plan, before all plan liabilities are satisfied.[8] Specifically, it must be impossible for the employer (or any other nonemployee) to recover any amounts from the trust, other than amounts that remain in the trust after all obligations under the Plan (fixed and contingent) have been satisfied.[9]

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[6] IRC § 401(a)(1).

[7] IRC § 401(a) initial language, and § 401(a)(2); *see also*, Cal. Const. art. XVI, § 17(a) ("The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.").

[8] IRC § 401(a)(2); Treas. Reg. §§ 1.401-1(a)(3)(iv) and 1.401-2.

[9] Treas. Reg. § 1.401-2(b)(2).

The Treasury Regulations issued under IRC section 401(a) state that a plan is not a qualified pension plan if it provides for the payment of benefits not customarily included in a pension plan, such as benefits for sickness, accident, hospitalization, or medical expenses. The only exception is for medical benefits described in IRC section 401(h).[10] Under section 401(h), a pension plan may provide for the payment of medical benefits for retired employees, their spouses, and their dependents, but *only* if the requirements of that section are met. One such requirement is that the medical benefits be paid from an account funded separately from the retirement fund.[11] SDCERS does not currently maintain a section 401(h) account to pay retiree health benefits, and the plan document does not allow SDCERS to establish one.

The City created and attempted to maintain a 401(h) account to pay retiree health benefits from 1998 until 2005, but never paid the required separate employer contributions (above the City's annual required contribution to the Retirement Plan) to fund the 401(h) account, which resulted in underfunding of the Retirement Plan. Before the City's failed attempt to pay retiree health benefits from a 401(h) account, the plan document required SDCERS to pay retiree health benefits and administrative expenses directly from plan assets. The IRS concluded these practices violated the qualification rules.

As part of a settlement with the IRS in 2008, detailed in the IRS Compliance Statement attached as Exhibit 2, the City agreed to adopt an IRS-approved ordinance correcting various qualification failures in the Retirement Plan. On April 28, 2008, the Council adopted San Diego Ordinance O-19740 (Apr. 28, 2008), which, among other things, repealed Municipal Code section 24.1203, the provision that had authorized and established the section 401(h) account. Thus, SDCERS legally cannot pay retiree health benefits or related administration costs.

## II. THE AGREEMENT TO INDEMNIFY SDCERS AGAINST CLAIMS ARISING FROM SDCERS' ADMINISTRATION OF RETIREE HEALTH BENEFITS DOES NOT VIOLATE PUBLIC POLICY.

SDCERS and the City wish to continue the practice of having SDCERS perform some of the duties associated with administering the City's retiree health benefits. Under these circumstances, it is permissible for the City to agree to defend and indemnify SDCERS for claims arising out of SDCERS' activities related to administering retiree health benefits.

The indemnity provision in the proposed MOU states:

> 6. **Indemnification and Defense**: The City agrees to indemnify, defend and hold harmless the Trustees of the Board, SDCERS, its agents, officers, employees, directors and assigns against any loss, cost, claim, suit, damage, liability or expense, including reasonable attorneys' and expert fees and defense costs, arising (a) out of any audit, investigation, subpoena, investigative demand action, action, proceeding, liability, judgment, settlement or inquiry or action of any other department of the City, any other government agency or entity or any other person or entity relating to SDCERS'

[10] Treas. Reg. § 1.401-1(b)(1)(i).
[11] IRC § 401(h)(2).

> performance under this Agreement; or (b) from any inaccurate or incomplete data provided or any non-compliance with the provisions of the Municipal Code or the Charter or retiree health plans relating to SDCERS' performance under this Agreement. The rights provided in this paragraph will survive termination of the MOU.

An agreement to indemnify another party against the consequences of a future act violates public policy *only* if it the parties have prior knowledge that the act is unlawful, such that the agreement serves to encourage or induce the unlawful act.[12] An indemnity agreement does not violate public policy, however, if the parties to the agreement: (1) do not have actual knowledge that the act is illegal at the time they enter into the agreement, and (2) the indemnified act is performed in good faith.[13] In addition, an indemnity agreement does not violate public policy if the indemnified party's negligence is only an undesirable incident of the agreement, and not a result induced by the agreement.[14]

The purpose of the MOU is not to induce SDCERS to do an unlawful act, but rather to memorialize the terms under which SDCERS will provide administrative services related to the City's retiree health benefits. Any negligent acts committed by SDCERS would be incidental to the MOU, not its intended result. Thus, the indemnity provision does not violate public policy.

## III. THE AGREEMENT TO WAIVE THE CITY'S RIGHT TO COLLECT DAMAGES AGAINST SDCERS DOES NOT VIOLATE PUBLIC POLICY.

The "Limitation of Liability" provision in the proposed MOU requires the City to waive its right to collect damages against SDCERS related to SDCERS' performance under the MOU. It provides, in pertinent part:

> The City acknowledges that all assets SDCERS holds are held in trust for the benefit of its Members, Beneficiaries and Participants, and City waives the right to collect damages of any amount or nature from SDCERS, regardless of SDCERS' negligence.

The Rules Committee has asked whether the City may agree to waive its right to collect damages arising out of SDCERS' negligence.

The contractual provision quoted above is an "exculpatory clause," in that it deprives one contracting party of its right to recover for damages suffered due to the other contracting party's negligent acts.[15] This is in contrast to the indemnity provision discussed in the previous section of this Memorandum, which is an agreement by one contracting party to pay or reimburse damages awarded to a third party against the other contracting party.

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[12] Cal. Civ. Code § 2773.
[13] *Stark v. Raney*, 18 Cal. 622, 624 (1861); *Lemat Corp. v. American Basketball Ass'n.*, 51 Cal. App. 3d 267, 279-280 (1975).
[14] *Branagh & Sons v. Witcosky,* 242 Cal. App. 2d 835, 839-841 (1966).
[15] *Black's Law Dictionary,* p. 648 (9th ed. 2009)).

Exculpatory provisions are more closely scrutinized than indemnity provisions. As the courts have explained, "an exemption may deprive a victim of compensation for injuries but an agreement to indemnify a person who may be responsible for a loss is additional assurance that the loss will be compensated."[16]

Unlike an agreement to indemnify, an exculpatory provision is void if it involves or impairs "the public interest." For example, in *Tunkl v. Regents of the University of California*,[17] the California Supreme Court held that a charitable research hospital could not enforce a release from liability for future negligence that it required patients to sign as a condition of admission. The Court found that the contract impaired the public interest, because the hospital held itself out to the public as an institution that performed services to qualified members of the public, and because it had a decisive advantage in bargaining. The Court contrasted that situation with private business transactions, stating:

> While obviously no public policy opposes private, voluntary transactions in which one party, for a consideration, agrees to shoulder a risk which the law would otherwise have placed upon the other party, the above circumstances pose a different situation. In this situation the releasing party does not really acquiesce voluntarily in the contractual shifting of the risk, nor can we be reasonably certain that he receives an adequate consideration for the transfer. Since the service is one which each member of the public, presently or potentially, may find essential to him, he faces, despite his economic inability to do so, the prospect of a compulsory assumption of the risk of another's negligence. The public policy of this state has been, in substance, to posit the risk of negligence upon the actor; in instances in which this policy has been abandoned, it has generally been to allow or require that the risk shift to another party better or equally able to bear it, not to shift the risk to the weak bargainer.[18]

The Court summarized its finding of a public interest as follows:

> In brief, the patient here sought the services which the hospital offered to a selective portion of the public; the patient, as the price of admission and as a result of his inferior bargaining position, accepted a clause in a contract of adhesion waiving the hospital's negligence; the patient thereby subjected himself to control of the hospital and the possible infliction of the negligence which he had thus been compelled to waive. The hospital, under such circumstances, occupied a status different than a mere private party; its contract with the patient affected the public interest.[19]

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[16] *Lemat*, 51 Cal. App. 3d at 278.
[17] *Tunkl v. Regents of the University of California*, 60 Cal. 2d 92 (1963).
[18] *Id.* at 101.
[19] *Id.* at 102.

It is unlikely that a court would find that that the proposed MOU affects or impairs the public interest. SDCERS and the City are in relatively equal bargaining positions. The City is better able than SDCERS to compensate injured parties for claims arising from the administration of retiree health benefits, because SDCERS' only assets are in the retirement trust fund and cannot be used for claims related to non-pension benefits. Finally, unlike a patient needing treatment at a hospital, the City is free to find another party to administer its retiree health benefits, or to administer the benefits itself.

Even if it does not affect or impair the public interest, an exculpatory clause is void, under California Civil Code section 1668, to the extent it seeks "to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent . . . ." The California Supreme Court has applied this section to "gross negligence," stating in *City of Santa Barbara v. Superior Court*, that "public policy generally precludes enforcement of an agreement that would remove an obligation to adhere to even a *minimal* standard of care."[20]

In *City of Santa Barbara v. Superior Court,* the city sought to enforce a release of liability on an application form it required parents to sign before their children could participate in a summer camp for developmentally disabled children. The form purported to release the city from liability for "any negligent act." The mother of a disabled child who had signed the release sued the city for wrongful death, after her child drowned at the summer camp. The Court held that the release was enforceable as to acts of ordinary negligence, but not as to acts of gross negligence.[21]

Based upon *City of Santa Barbara v. Superior Court,* this Office asked SDCERS to remove the reference to gross negligence in the proposed MOU. SDCERS agreed, and the MOU now states that the City waives its right to collect damages from SDCERS "regardless of SDCERS' negligence." Even without this change, the City would not violate public policy by entering into the MOU. However, public policy may have barred SDCERS from relying on the provision to shield itself from liability for acts of gross negligence.

## IV. THE CITY IS PROBABLY NOT ASSUMING ANY ADDITIONAL RISK BY APPROVING THE MOU, AS THE CITY IS VICARIOUSLY LIABLE FOR THE ACTS OF ITS EMPLOYEES IN THE SCOPE OF EMPLOYMENT, REGARDLESS OF WHETHER THOSE EMPLOYEES WORK AT SDCERS OR THE RISK MANAGEMENT DEPARTMENT.

SDCERS has indicated that it will no longer continue to administer the City's retiree health benefits without the agreement to defend and indemnify SDCERS against claims arising from its administration of these benefits. Therefore, the City faces a choice between: (1) having SDCERS continue in its role in assisting the City to administer retiree health benefits, with the City's agreement to indemnify SDCERS for claims arising from these activities, and (2) having another entity, such as the City's Risk Management Department or an independent contractor,

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[20] *City of Santa Barbara v. Superior Court*, 41 Cal. 4th 747, 777 (2007).
[21] *Id.* at 786.

administer retiree health benefits.[22] The risks associated with not having SDCERS administer the retiree health benefits cannot be fully assessed without knowing how the City will proceed if the Council does not approve the MOU. The City's current risk of liability can, however, be compared with the risk of liability if the City agrees to indemnify SDCERS.

The City may not be assuming any additional risk of liability by entering into the MOU. The Board has no role in administering the retiree health benefits. All of the administrative services SDCERS provides related to retiree health benefits are performed by *City* employees working at SDCERS. Regardless of whether these administrative functions are performed by City employees at SDCERS or City employees in the Risk Management Department, the City is vicariously liable for the actions of these employees when they are acting in the scope of their employment.

Employers in California are vicariously liable for reasonably foreseeable torts committed by their employees within the scope of their employment.[23] In addition, a public agency employer is "is liable for injury proximately caused by an act or omission of an employee of the public entity within the scope of his 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."[24] The primary justification for holding employers liable for the acts of their employees is "that losses fairly attributable to an enterprise – those which foreseeably result from the conduct of the enterprise – should be allocated to the enterprise as a cost of doing business."[25] Even an employee's willful, malicious or criminal torts may fall within the scope of employment and give rise to vicarious liability, provided there is a causal nexus to the employee's work.[26]

In addition to liability for acts committed by their employees, a public entity employer is obligated to defend an employee in a civil action arising from the scope of employment, and to pay any claim or judgment against the employee in favor of a third party plaintiff.[27]

Even without the MOU, the City is vicariously liable for the actions of its employees, including those related to administering retiree health benefits. The City is also obligated to defend and indemnify its employees for civil actions that arise out of retiree health benefit administration. This is the case regardless of whether these City employees work at SDCERS' or the City's Risk Management Department. Since the services under the MOU will be performed by City employees, it is unlikely that the City, by signing the MOU, would be assuming any liability that it has not already assumed.

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[22] Before the City may approve a contract with an independent contractor to do work currently performed by City employees, the City must first follow the procedural requirements of Charter section 117(c). *See* 2009 Op. City Att'y 710 (2009-2; Oct. 8, 2009).

[23] *Perez v. Van Groningen & Sons, Inc.*, 41 Cal. 3d 962, 967 (1986).

[24] Cal. Gov't Code § 815.2(a).

[25] *Farmers Ins. Group v. County of Santa Clara*, 11 Cal. 4th 992, 1004 (1995).

[26] *Carr v. Wm. C. Crowell Co.*, 28 Cal. 2d 652 654 (1946) (building contractor was liable when an employee became angry and threw a hammer at another worker's head, because dispute arose out of work); *Mary M. v. City of Los Angeles*, 54 Cal. 3d 202, 221 (1991) (police officer who misused his official authority to rape a woman he had detained was acting in the scope of his employment, and his public agency employer could be held vicariously liable).

[27] Cal. Gov't Code §§ 825-825.6 and 995-996.6.

## CONCLUSION

SDCERS' only assets are held in trust to administer and pay benefits under the Retirement Plan. These trust fund assets cannot be used to pay or administer retiree health benefits, or to defend against or pay claims arising from administering these benefits. SDCERS has indicated that it will not continue to assist the City to administer retiree health benefits without an agreement to defend and indemnify SDCERS and to waive all claims against SDCERS in connection with administering these non-Retirement Plan benefits.

The services SDCERS provides with respect to the retiree health benefits are performed by City employees. Even without an agreement to indemnify SDCERS, the City is vicariously liable for the actions of these employees when they are acting in the scope of their employment. Although the MOU assures SDCERS that its assets and tax qualification will not be put at risk by its performance of non-pension administrative functions, the MOU does not really increase the City's risk of liability.

By */s/ Roxanne Story Parks*
Roxanne Story Parks
Deputy City Attorney

RSP:ccm
Attachments
CA Report RC-2013-16
Doc. No. 670738

SDCERS
San Diego City Employees' Retirement System

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October 21, 2013

Council President and City Council
City of San Diego
City Administration Building
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San Diego, CA 92101

RE: SDCERS Retiree Health MOU

Dear City Council Members:

At the October 9, 2013 Rules Committee Meeting you were asked to consider the proposed Memorandum of Understanding ("MOU") between SDCERS and the City concerning SDCERS' involvement in processing retiree health benefits for retired City employees. SDCERS understands that this matter has been continued to a future meeting for further consideration. The purpose of this letter is to explain the necessity for that MOU.

**The Exclusive Benefit Rule Prohibits SDCERS From Using Trust Funds Assets to Defend Against Claims and Litigating Arising Out of Retiree Health Operations**

Unlike the usual commercial situation where parties to a contract enter into mutual promises to defend and indemnify based on which party's negligence caused liability exposure, SDCERS' position as administrator of the City's retirement plan mandates that it receive a unilateral promise of indemnification from the City where SDCERS performs duties for the City other than those required to administer the pension benefits provided in the City's retirement plan.

Trust fund assets held by a pension system, like SDCERS, are to be used for the sole purpose of paying promised benefits of the plan and related administrative expenses. (Internal Revenue Code §401(a); Art. XVI, §17 of the California Constitution and Article IX of the City Charter.) This is known as the Exclusive Benefit Rule. Retiree health is not a promised benefit of the pension plan and SDCERS cannot use plan assets to either fund retiree health benefits or pay for administrative expenses related to the processing of those benefits. To do otherwise would violate the Exclusive Benefit Rule and risk the tax-qualified status of the Plan.

EXH. 1

Thus, even if the claim or litigation arises out of SDCERS' negligence or "gross negligence," SDCERS cannot expend trust fund assets to defend or pay any claim or judgment. Those administrative expenses must be paid by the City. In the recent past, despite a clear legal duty to defend and indemnify, the City has at times refused indemnification to City employees, including those sitting on the SDCERS Board ("Board"), for activities arising out of their City duties. And, unlike the indemnification owed to City employees, there is no provision in the California Government Code requiring the City to indemnify SDCERS, the entity, when it is named in litigation.

Without an MOU guaranteeing a defense and indemnification, SDCERS' continued involvement in retiree health processing risks exposure to liability for claims against which it cannot defend without risking the tax-qualified status of the plan. SDCERS must eliminate this exposure or be in breach of its fiduciary duties.

Approval of the MOU is at the City Council's discretion. Should the City Council determine not to approve the MOU, then the Board must evaluate whether it can, consistent with its fiduciary duties to the System and the membership, continue its retiree health operations on behalf of City employees or work with the City to find some reasonable alternative.

**History of SDCERS' Retiree Health Operations Leading Up To This Request:**

From the inception of the City's retiree health program, SDCERS has been involved in processing retiree health benefits for the City. At one time, retiree health benefits were funded by "excess" earnings of the System and paid from trust fund assets. During later years, retiree health benefits were paid through a 415(h) trust managed by SDCERS.

In 2005, subsequent to the passage of Proposition H changing the Board composition, the Board retained Navigant Consulting to conduct an investigation of the administration of SDCERS. One of the areas Navigant looked at was SDCERS' processing of retiree health for City employees. Navigant issued its report on January 20, 2006, addressing retiree health at Section VIII (commencing on page 89) of the Navigant Report. Regarding administrative expenses incurred by SDCERS related to retiree health processing, Navigant noted that the costs to run the retiree health program appeared to have been paid with pension assets instead of being separately paid by the City. Navigant recommended that these costs be quantified and reimbursed by the City. [Id. at page 91.]

In July 2005, SDCERS entered into the IRS Voluntary Compliance Program ("VCP") resulting in a full review by the IRS of SDCERS' implementation of the City's plan. The use of pension assets to fund and administer City retiree health benefits was one of the operational failures reviewed by the IRS. As a result of the VCP process, SDCERS, the City and the IRS entered into an agreement known as the Compliance Statement. The Compliance Statement was signed

by SDCERS Board President and the City Chief Operating Officer on December 20, 2007. One of promises made to the IRS by SDCERS and City in the Compliance Statement was that retiree health (including administrative expenses) would be funded directly by the City and not out of plan assets. The proposed MOU will guarantee that this promise is kept.

Shortly after the Compliance Statement issued, SDCERS began to evaluate its involvement with retiree health, working with City officials to balance the City's needs with those of SDCERS. Ultimately, City officials expressed the desire to have SDCERS continue with its retiree health operations and negotiations commenced over the terms of the MOU, with the final product being presented to the Rules Committee. The City's Risk Management Department, City Attorney and SDCERS staff are all in agreement with the proposed MOU.

As explained above, because SDCERS cannot expend trust assets to defend against or pay claims arising out of its retiree health operations, it requires that the City agree to defend and indemnify SDCERS against all such claims, regardless of whether they arise out of SDCERS' negligence, gross negligence or otherwise. SDCERS requests that the City Council approve this MOU.

Sincerely,

Elaine W. Reagan
General Counsel/Chief Compliance Officer

cc: Todd Gloria, Interim Mayor
Jan Goldsmith, City Attorney
Edward Kitrosser, SDCERS Board President
Mark Hovey, SDCERS CEO

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

January 10, 2008

**Local contact address:**
Internal Revenue Service
SE:T:EP:RA:VC
1111 Constitutional Ave. NW PE4G7
Washington, DC 20224

Roxanne Story Parks, Chief Compliance Officer
San Diego City Employees' Retirement System
401 West A Street, Suite 400
San Diego, CA 92101

Re: Compliance statement for: San Diego City Employees' Retirement System
Control Number: 911659038
Employer Identification Number: 20-1800126
Plan No.: 001

Dear Ms. Parks:

Enclosed is the compliance statement for the San Diego City Employees' Retirement System. A compliance statement constitutes an enforcement resolution solely with respect to certain failures of an employee retirement plan that is intended to satisfy the requirements of the Internal Revenue Code. It does not constitute a ruling letter within the meaning of Revenue Procedure 2008-4, 2008-1 I.R.B. 121, or a determination letter within the meaning of Revenue Procedure 2008-6, 2008-1 I.R.B. 192. The compliance statement should not be construed as affecting the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

The determination letter associated with your related application that was part of your Voluntary Correction Program submission will be issued under separate cover.

At a later date, you may be required to verify that the correction of the failures and any modification of administrative procedures (upon which your enforcement resolution is conditioned) have been timely made.

Copies of this compliance statement and of this letter have been sent to your authorized representative in accordance with a power of attorney on file in this office. If you have any questions, please contact Paul C. Hogan, ID# 91-07322 by phone at 206-220-6085 or by fax at 206-220-6071.

Sincerely,

Joyce Kahn
Manager, EP Voluntary Compliance

Enclosure(s):
Compliance statement

cc: Mary Beth Braitman/Terry Mumford of Ice Miller LLP

EXH. 2

INTERNAL REVENUE SERVICE
VOLUNTARY CORRECTION PROGRAM
COMPLIANCE STATEMENT

Date: JAN 1 0 2008
(to be completed by IRS)

Re: San Diego City Employees' Retirement System
SE:T:EP:RA Control Number: 911659038
Employer Identification Number: 20-1800126
Plan No.: 001

## I. APPLICANT'S DESCRIPTION OF QUALIFICATION FAILURE(S)

The City of San Diego ("Plan Sponsor") is the principal sponsor of the San Diego City Employees' Retirement System ("Plan"). In accordance with state and local laws, the Board of Administration For The San Diego City Employees' Retirement System ("the Applicant") is responsible for the daily administration in regard to the Plan, and has submitted a request to the Internal Revenue Service ("the Service") under the Voluntary Correction Program for a compliance statement relating to various qualification failures under section 401(a) of the Internal Revenue Code ("Code") that they have identified. The Plan uses the twelve-month period that ends on June 30 as its plan year. The Plan is a multiple employer defined benefit pension plan that has also been adopted by the San Diego Unified Port District and the San Diego County Regional Airport Authority. The Plan is also considered a governmental plan under Code section 414(d).

### Failure #1

The Plan was not amended to comply with all of the applicable requirements of the Tax Reform Act of 1986 ("TRA '86"), the Unemployment Compensation Amendments of 1992 ("UCA"), and the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") by the required dates in accordance with section 401(b) of Code and regulations thereunder.

### Failure #2

The Plan was not amended to comply with all of the applicable requirements of the Uruguay Round Agreements Act; the Uniformed Services Employment and Reemployment Rights Act of 1994; the Small Business Job Protection Act of 1996; the Taxpayer Relief Act of 1997; the Internal Revenue Service Restructuring and Reform Act of 1998; and the Community Renewal Tax Relief Act of 2000 (collectively known as "GUST") by the required dates in accordance with section 401(b) of the Code and regulations thereunder.

Failure #3

The Plan was not amended to incorporate the interim amendments required for compliance with the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") by the required date(s) in accordance with section 401(b) of the Code and regulations thereunder.

Failure #4

During the plan years that ended in 1989 through 2008, the terms of the Plan provided special retirement benefits to past and current union presidents of the San Diego Municipal Employees' Association, Police Officers' Association, and Local 145, the International Association of Fire Fighters AFL-CIO ("Unions") that were not permitted by the Code. Under Code section 401(a), retirement benefits in a qualified plan can only be provided to employees of an employer and such benefits are generally based solely on service with and compensation paid by such employer. Specifically, the following problems were noted:

(a) The Presidential Leave Program allowed former city employees who were no longer paid employees of the Plan Sponsor to continue to participate in the Plan as active participants and have their service as union presidents counted as credited service in determining retirement benefits under the Plan.

(b) From 1989 through February 2004, the Plan accepted employee and employer contributions (based upon compensation paid by the Unions) that were paid by the Unions even though they had not adopted the Plan as participating employers.

(c) Starting in 2002, the Incumbent President Program allowed compensation that was paid to the union presidents by the Unions to be counted in the determination of retirement benefits under the Plan, and such amounts would be combined with any other compensation paid by the Plan Sponsor subject to a specified dollar cap.

Failure #5

Starting in the plan year that ended in 2003 the terms of the Plan were amended to provide for an impermissible cash or deferred arrangement in violation of the Code section 401(a) in regard to the Cashless Leave Conversion Program that was offered to participants who were members of San Diego Firefighters Local 145 bargaining unit.

Failure #6

During the plan years that ended in 1983 through 1991 retiree health benefits were paid by the Plan even though the terms of the Plan did not provide for such benefits. Also, the Applicant represents that the Plan is owed additional funds from the Plan Sponsor relating to unreimbursed administrative expenses associated with the administration of the retiree health benefit account from 1993 through 2006. Both actions were in

violation of Code section 401(a)(2). The Applicant represents that the accumulated amount of improper payments (plus interest) associated with this failure is $33,830,251.

Failure #7

During the plan years that ended in 1998 through 2005 the terms of the Plan and its operation did not comply with all of the requirements of Code sections 401(a)(2) and 401(h) as they relate to retiree health benefits because the terms of the Plan provided that earnings of the trust would ultimately be used to fund these benefits resulting in the underfunding of the Plan. While retiree health benefits were paid from the Plan's retiree health account as required by the Code, the flow of funds was structured in a manner which made it extremely difficult, if not impossible to resolve that there was no inappropriate use of the Plan's assets.

Failure #8

During the plan years that ended in 1989 through 2004 the Applicant did not comply with the provisions of Code section 401(a)(9) with respect to required minimum distributions in regard to Plan participants who were owed a lump sum or a partial lump sum distribution. With respect to this failure, the Applicant requests a waiver of the excise tax under Code section 4974.

Failure #9

During the plan years that ended in 2000 through 2005 the Applicant allowed the retirement benefits for three participants to be determined using participant compensation that exceeded the limits imposed by the provisions of Code section 401(a)(17).

Failure #10

During the plan years that ended in 2002 through 2006 the Applicant did not comply with the provisions of Code section 401(a)(31) in regard to those participants who received eligible rollover distributions from the Plan.

Failure #11

During the plan years that ended in 2001 through 2006 the Applicant did not follow the terms of the Plan when the Applicant increased disability retirement benefits in regard to disabled plan participants by increasing their final compensation amount by 10% and using this revised figure to determine disability benefits. The Applicant represents that overpayments were made to 146 participants and that the accumulated amount of overpayments plus interest associated with this failure is $1,221,543.

Failure #12

During the plan years that ended in 1996 through 2007 the Applicant did not comply with the provisions of the Code when it allowed the Plan to pay out benefits that exceeded the limits imposed by Code section 415(b). The Applicant represents that overpayments were made to approximately 58 participants and that the accumulated amount of overpayments plus interest associated with this failure is approximately $4,209,221.

Failure #13

From January 1, 2005, through the present, the Applicant has allowed the Plan to provide spousal death benefits to registered domestic partners even though such benefits are not provided for under the terms of the Plan.

Failure #14

Starting on July 26, 2004, the Plan Sponsor has made contributions to the Plan that exceeded what was called for under the terms of the Plan section 24.0801 as set forth in the Memoranda of Understanding (November 18, 2002) between the Plan Sponsor and the Applicant. These payments resulted from the settlement of a class action court lawsuit (Gleason v. City of San Diego) involving the Plan Sponsor and the Applicant regarding the level of contributions that needed to be paid to the Plan.

II. APPLICANT'S CORRECTION

Failures #1 & 2

The Plan Sponsor and each participating employer will correct the qualification failure by adopting amendments in the form of a city ordinance that will allow the terms of the Plan to fully comply with all of the requirements of TRA '86, UCA, OBRA '93 and GUST retroactively to the effective dates of the specific provisions contained in the amendments. To assist in this matter, the proposed amendment will include draft Board rules that will be adopted by the Applicant.

Failure #3

The Plan Sponsor and each participating employer will correct the qualification failure by adopting interim amendments that satisfy the requirements of EGTRRA retroactively to the applicable effective dates of the specific provisions contained in the amendments.

Failure #4

The Plan Sponsor will amend the Plan retroactively to remove any provisions relating to Presidential Leave, including the Incumbent President Program. The resulting changes to the Plan will indicate that benefits and participation under the Plan are limited to employees of the Plan Sponsor and any other participating employers that have adopted the Plan and that retirement benefits would be based solely on paid compensation and service associated with the Plan Sponsor or other particating employers.

In regard to any employee contributions that were either paid to the Plan directly by the Unions or derived from compensation paid by the Unions such funds will be returned to the affected plan participants along with accumulated interest. The distribution of these monies will be a taxable distribution to each affected participant and such distribution will not be subject any favorable tax treatment under the Code. The Applicant will send a letter to each participant informing the participant that the corrective distribution is taxable, not eligible for favorable tax treatment and cannot be rolled over as normally allowed under Code section 402(c). The Applicant also agrees that the distribution will be reported on Form 1099-R for the calendar year in which the distribution is made to the affected participants. The Applicant will return to the Unions the employer contributions that were paid to the Plan to by the Unions.

For all impacted participants, the Applicant will recalculate their benefits under the Plan and the Plan's records will be updated to reflect reduced benefits and service credits. Retirement benefits under the Plan, including the Deferred Retirement Option Plan ("DROP"), will be determined without using any compensation paid by the Unions and any union service will also be disregarded in any computations unless such service has already been purchased by the participants under the Plan's regular service purchasing provisions. For those impacted participants who are in retirement status, the monthly annuity that is currently being paid by the Plan will be reduced to the recalculated amount. The Applicant will recover any overpayments that have been paid to affected participants via an offset against the return of employee contributions mentioned in the preceding paragraph, by direct repayment to the Plan by the affected participants or by a special actuarial reduction to the corrected monthly pension benefit on a going forward basis.

Failure #5

The Plan Sponsor will amend the Plan retroactively to remove any provisions relating to the Cashless Leave Conversion Program. This change will remove the impermissible cash or deferred arrangement from the Plan.

For all plan participants who took part in the Cashless Leave Conversion Program, the Applicant will recalculate their benefits under the Plan and the Plan's records will be updated to reflect reduced benefits and service credits. Retirement benefits under the Plan, including DROP, will be determined without regard to cashless leave amounts. For those impacted participants who are in retirement status, the monthly annuity that is currently being paid by the Plan will be reduced to the recalculated amount. The Applicant will recover any overpayments that have been paid to retired plan participants by reducing the revised monthly pension benefit further on a going forward basis via a special actuarial reduction that allows the overpayment to be recouped over the participant's remaining payment period.

Failure #6

The Applicant and Plan Sponsor have represented to the Service that the Plan Sponsor has fully corrected this failure by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory actuarial required contributions ("ARC").

Failure #7

The Applicant and Plan Sponsor agree that in order to comply with all of the requirements of Code sections 401(a) and 401(h) the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded (directly or indirectly) from pension assets, including plan earnings. Effective as of July 1, 2005, retiree health benefits were no longer paid out of the Plan's 401(h) account. Instead, such benefits were paid directly by the Plan Sponsor without the involvement of the Plan. To codify this action, the Plan Sponsor will amend the Plan to retroactively to remove these provisions effective as of July 1, 2005.

Failure #8

The Applicant represents that no annuity payments were paid in violation of the required minimum distribution requirements. The Applicant represents that the lump sum or partial lump sum payments have been made to all affected participants who were past their required minimum distribution date. The distribution amounts included additional amounts for interest relating to the delayed payment.

Failure #9

In terms of one affected participant who terminated without a vested pension, the Applicant represents that the failure only resulted in the computation of excess employee contributions and that no additional action needs to be taken since the excess amounts of $420.89 were paid out as a lump sum in 2002 that was not rolled over.

In terms of the other two affected participants, the Applicant will recalculate their benefits under the Plan and the Plan's records will be updated to reflect reduced

benefits. Retirement benefits under the Plan, including DROP, will not be determined using participant compensation that exceeds the limits imposed by Code section 401(a)(17). The Applicant will distribute the employee contributions associated with the excess compensation plus interest to the affected participants. The Applicant will send a letter to each participant informing them that the corrective distribution is taxable, not eligible for favorable tax treatment and cannot be rolled over as normally allowed under Code section 402(c). The Applicant also agrees that the distribution will be reported on forms 1099-R for the calendar year in which the distribution is made to the affected participants.

Failure #10

The Applicant has proposed to take no action in regard to the past distributions that were made during the period of failure. As noted previously for Failure #1, the Plan Sponsor will amend the Plan to contain language that allows it to meet the statutory requirements of Code section 401(a)(31). The Applicant has changed its administrative procedures in order to ensure that all future eligible lump sum distributions paid out by the Plan will comply with the requirements of Code section 401(a)(31).

Failure #11

The Applicant has stopped paying out excess disability benefits that are not authorized by the terms of the Plan and the 10% compensation adjustment is no longer applied in computing these benefits. In regard to the overpayments that were paid out during the period of failure, the Applicant and Plan Sponsor have represented to the Service that the Plan Sponsor has fully reimbursed the Plan by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory ARC contributions.

Failure #12

The testing methodology that was used by the Applicant to determine an individual's limit under Code section 415(b) during the period of failure is set forth within the document entitled "San Diego City Employees Retirement System 415(b), (c) and (n) Compliance Strategy Report" with a revision date of December 5, 2007 prepared by the Applicant's representative, Ice Miller as supplemented by Exhibits A and B with the same revision date prepared by the actuary, Cheiron. These documents are considered attached to and made a part of this compliance statement.

The Applicant has agreed that payments from the Plan during this current limitation year will not exceed the limits of Code section 415(b). If necessary, the payments being made to current retirees and/or beneficiaries will be reduced by the Applicant in order to ensure that the benefits paid out by the Plan do not exceed the applicable limits of Code section 415(b).

The Applicant and Plan Sponsor have represented to the Service that repayments of the overpayments should not come from the affected participants since the Plan Sponsor is obligated to pay these excess benefits due to the existence of a Code section 415(m) plan and the laws of State of California. The Applicant and Plan Sponsor have also represented to the Service that the Plan Sponsor has fully reimbursed the Plan in regard to the overpayments plus interest by having made supplemental contributions to the Plan during the plan years ending in 2006, 2007 and the current plan year that exceeded the amounts specified by the Plan's actuary in regard to the mandatory actuarial required contributions ("ARC").

Failure #13

The Plan Sponsor will retroactively amend the terms of the Plan to conform to the Plan's operation in regard to this matter.

Failure #14

The Plan Sponsor will retroactively amend the Plan to indicate that the amount of employer contributions that must be paid to the Plan by the Plan Sponsor will no longer be based upon any Memoranda of Understanding between the Plan Sponsor and the Applicant. The amendment will be effective as of July 26, 2004 and it will allow the terms of the Plan to conform to the Plan's operation in regard to this matter.

III. APPLICANT'S REVISION OF ADMINISTRATIVE PROCEDURES

Failures #1, 2 & 3

The Applicant is working with outside tax counsel who will advise them in regard to changes in the Code that require amendments to be made to the Plan. The Applicant and Plan Sponsor will work together to ensure that the Plan document is updated in a timely manner for tax law changes. The Applicant has indicated that it will apply for a Cycle C determination letter in accordance with the applicable timeframes currently set forth in Revenue Procedure 2007-44.

Failure #4

The Applicant no longer permits the Unions to make any contributions to the Plan. Only contributions from the Plan Sponsor and participating employers will be accepted. The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) requirements.

Failure #5

The Plan Sponsor will not adopt any future amendments to the Plan that result in a cash or deferred arrangement. The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) requirements.

Failure #6

The Applicant has changed its procedures and it and the Plan Sponsor now realize that retiree health benefits cannot normally be paid by the Plan and that the expense of administering retiree health benefits cannot come from the Plan's assets.

Failure #7

The Applicant has hired outside tax counsel who will assist in ensuring that future changes to the Plan are in compliance with Code section 401(a) and other applicable requirements under the Code.

Failure #8

The Applicant has implemented a new annual monitoring system that will ensure that all required minimum distributions begin on a timely basis and include benefits under the Plan with respect to all types of Plan participants and beneficiaries.

Failure #9

The Applicant has revised its software, testing protocols and internal reports to monitor participant compensation and cut it off when it reaches the appropriate limits under Code section 401(a)(17). Employee contributions will be cutoff and no retirement benefits will be based on the excess compensation.

Failure #10

The Applicant has educated its workforce in regard to the various benefits of the Plan that are subject to Code section 401(a)(31) by creating a detailed chart. Formal, detailed procedures that reflect how the Plan will comply with Code section 401(a)(31) have been written and the Applicant will use these documents when administering the Plan in regards to this matter.

Failures #11, 13 & 14

The Applicant agrees not to administer the Plan and/or provide benefits in a manner that is not explicitly authorized by the Plan. If the Applicant believes that the Plan's operation needs to be changed it will work with its tax counsel and the Plan Sponsor to have the Plan amended before changing the Plan's operation.

Failures #12

The Applicant has revised its administrative procedures for ensuring the Plan's compliance with the limits of Code section 415(b) as detailed within the previously referenced document entitled "San Diego City Employees Retirement System 415(b), (c) and (n) Compliance Strategy Report" with a revision date of December 5, 2007 prepared by the Applicant's representative, Ice Miller as supplemented by Exhibits A and B with the same revision date prepared by the actuary, Cheiron.

## IV. APPLICANT'S PAYMENT

The Plan Sponsor and Applicant will neither attempt to nor otherwise amortize, deduct, or recover from the Service any compliance fee paid in connection with this compliance statement, nor receive any Federal tax benefit on account of payment of such compliance fee.

## V. ENFORCEMENT RESOLUTION

The Service will not pursue the sanction of plan disqualification on account of the qualification failure(s) described in Part I. The Service will waive the excise taxes under Code section 4974 on account of the qualification failure(s) described in Failure 8.

The Service will treat the amendment(s) described in Failure number 3 as if they had been timely adopted for the purpose of making available the extended remedial amendment period currently set forth in Revenue Procedure 2007-44, 2007-28 I.R.B. 54. However, this compliance statement does not constitute a determination as to whether any such plan amendment(s), as drafted, complies with the applicable change in qualification requirements.

San Diego City Employees' Retirement System

This compliance statement considers only the acceptability of the correction method(s) and the revision(s) to administrative procedures described in the submission and does not express an opinion as to the accuracy or acceptability of any calculations or other material submitted with the application. In no event may this compliance statement be relied on for the purpose of concluding that the Plan or Plan Sponsor (as defined in the applicable revenue procedure setting forth the Employee Plans Compliance Resolution System) was not a party to an abusive tax avoidance transaction. The compliance statement should not be construed as affecting the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

This compliance statement is conditioned on (1) there being no misstatement or omission of material facts in connection with the submission, and (2) the completion of all corrections described in Parts II and III within one hundred fifty (150) days of the date of the compliance statement.

By signing this compliance statement, the Plan Sponsor and Applicant hereby agree to its terms.

The City of San Diego

By: _____

Title: COO

Date: 12/20/07

Board of Administration For The San Diego City Employees' Retirement System

By: Thomas C Nebrant

Title: President, Board of Administration

Date: 12/20/07

Approved: _____
Joyce Kahn, Manager
Employee Plans Voluntary Compliance
Tax Exempt and Government Entities Division

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