MEMORANDUM OF LAW

DATE: July 7, 1993

TO: Lawrence B. Grissom, Retirement Administrator

FROM: City Attorney

SUBJECT: Proposals From Coalition of Retired City Employees

Pursuant to your request, we have reviewed a proposal prepared by the Coalition of Retired City Employees whereby undistributed earnings would be awarded amongst employees, retired employees, and the City of San Diego in the ratio of their respective reserve accounts. Our analysis, including responses to your specific questions concerning Section 143 of the Charter of The City of San Diego ("Charter") and San Diego Municipal Code ("SDMC") section 24.0907.1 follows.

Question No. 1: The City Charter, at section 143, requires the City to contribute annually to the Retirement System an amount "substantially equal" to that required of employees. My question is what constitutes "substantially equal?"

As an example, for fiscal year 1994, the most recent actuarial valuation indicates that the average employee contribution for a general member is 8.61% and the recommended rate for the City is 2.08%. On first blush, this would not appear to be a "substantially equal" relationship. However, the City additionally pays on behalf of general members the first 5.5% (6.0% for unclassified employees) of employee contributions. This essentially reverses the burden of payment, and again would not appear to be a "substantially equal" relationship. Thus a secondary question becomes what basis do we use to determine how we judge "substantially equal?"

Answer: Employer and employee contributions to the Retirement System are governed by Charter section 143. This section provides:

> SECTION 143. CONTRIBUTIONS.
>
> The retirement system herein provided for shall be conducted on the contributory plan, the City contributing jointly with the employees affected thereunder. Employees shall contribute according

> to the actuarial tables adopted by the Board of Administration for normal retirement allowances, except that employees shall, with the approval of the Board, have the option to contribute more than required for normal allowances, and thereby be entitled to receive the proportionate amount of increased allowances paid for by such additional contributions. The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, but shall not be required to contribute in excess of that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of the employees. The mortality, service, experience or other table calculated by the actuary and the valuation determined by him and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon.

San Diego City Charter section 143.

Generally, the Retirement System is conducted on a contributory plan where the City contributes jointly with the employees. Charter section 143; International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d 292, 297 (1983). Specifically, employees contribute according to the actuarial tables adopted by the Board for normal retirement allowances. The City, however, is required to "contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, ..."F As originally enacted, Charter section 143 provided that employees would contribute an amount not to exceed 5% of their salary or wage. The City was required to contribute "an equal amount." In 1945, Charter section 143 was amended to provide that employees would contribute to the Retirement Fund according to actuarial tables adopted by the Board for normal retirement allowances instead of an amount not to exceed 5% of their salary or

wage. The City's contribution was amended in 1954 to provide that "the City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, ..." There have been no further amendments since this date. See also, International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d 292, 297 (1983).
The entire system is based on actuarial advice. Id.

In your example, you highlight the average employee contribution for a general member (8.61%) and the recommended rate for the City (2.08%) set forth in the current actuarial report. You note that at first blush this does not appear to be a "substantially equal" relationship. The Charter, however, does not require equal contribution rates. It merely requires that the contributions flowing into the Retirement System, from the employer be at least "substantially equal" to that contributed by the employees. The Charter does not prohibit the City from paying more.

In this regard, "the charter operates not as a grant of power, but as an instrument of limitation and restriction on the exercise of power over all municipal affairs which the city is assumed to possess; and the enumeration of powers does not constitute an exclusion or limitation." Grimm v. City of San Diego, 94 Cal. App. 3d 33, 38 (1979). Absent a prohibition or other limitation against the City paying more than that required of its employees, the City is within its legal authority to pay more. Historically, this is what has in fact happened.

A Summary of Retirement Contributions prepared by the Auditor showing the contributions from the City and the employees since 1977 has been attached to this Memorandum of Law. The Summary of Retirement Contributions sets forth the City's contributions, the employee contributions paid by the City and the employee contributions from 1977-1993. The contributions made by the Unified Port District and its employees are also separately accounted for. Finally, for the years 1992 and 1993, there is also a line item entry for the City's contribution made to the Post Retirement Health Care Trust representing the change in the accounting for the post retirement health care benefit provided by the City.

According to this report, the City contributed $16,863,072 while the employees contributed $4,480,486 in 1977. While it is clear that the City paid over three times the amount paid by the employees, we find no violation of Charter section 143. Again, Charter section 143 sets a minimum threshold for the City's contribution. That minimum is the amount contributed by the employees. As long as that threshold is met, the City is free to

contribute in excess of that amount.

The implementation of the offset program in 1978 whereby the City pays a percentage of the employees' contribution has exacerbated the differences in the contributions made by the City and its employees. Beginning in 1978, the City began making employee contributions on behalf of its employees. Since that date and without exception, the City has paid a minimum of two times (1980, 1981) to a high of almost six times (1987) that paid by employees to the Retirement System.F

This conclusion is found by comparing the yearly figures representing the Total Paid By City listed under the Employers' Contributions with the yearly figures representing the Members' Contributions - City listed under the Employees' Contributions. Again, we find no problems with Charter section 143. In each year, without exception, the City has fulfilled its contribution obligation pursuant to the Charter.

Our conclusion is further supported by the decision reached by the California Supreme Court in International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d at 300. There the court was asked to review the Board's authority to increase the safety member contribution from 8.22% to 11.68% based on the advice of the Board's actuary.F

According to the California Supreme Court, the increase of the employee's rate of contribution recommended by the actuary and approved by the Board was based upon a recommendation by the American Academy of Actuaries ("Academy") to include and account for the impact of inflation on employees' future salaries. Historically, this factor had been disregarded because it was viewed as a short-term phenomenon. In 1976, the Academy acknowledged that inflation was here to stay for the foreseeable future. Hence, the addition of a new assumption in the actuarial evaluation and a corresponding increase in contribution rates. International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d at 296.

Finding the increase both permissible and warranted and referring to Charter section 143, the court stated:

> Prior to the 1978 rate increase, City's contributions to the system were more than twice as large as safety members'; after that increase, City still contributes approximately one and one-half times as much as such members. It is apparent that this shift thus merely makes City's

> contribution more "substantially equal" to that of the members, as City's retirement system requires. That system provides both the authority and the mechanism to revise members' rates, and the Board's increase appears to have been accomplished in conformity therewith, as the trial court found.
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> International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d at 300.

In closing on this issue, we highlight the contributions reported in the current actuarial report at page 47. During the period July 1, 1991 to June 30, 1992, contributions totaling $42,753,078 were made to the System. Of this amount, $13,402,162 represented employer contributions, $13,173,963 represented employee contributions and $16,176,953 represented employer offset contributions. Looking at these figures, we can find no violation of either the letter or the spirit of Charter section 143. The City has paid more than that required by the employees without exception. As such, it has not only met but has exceeded its burden to contribute an amount "substantially equal" to that of the employees.

Question No. 2: The SDMC at section 24.0907.1 directs the Board in the distribution of "surplus" undistributed earnings. Please review the points raised by the Coalition and advise me if there is any legal basis to their argument about the inequities of the distribution.

Answer: The central premise of the Coalition is that in recent years Retirement System improvements have been codified which benefit active members and future retirees to the detriment of current retired members. The Coalition does not give any specific example of such an improvement to the plan, however, the general theory they advance is that current earnings from the Trust Fund, generated in part from past contributions made by current retirees, have been and are being used to partially fund the actuarial liability created by new benefits and changes in formulas used to calculate new benefits.

The Coalition also raises issues of equity and legality with respect to the current distribution of "surplus" undistributed earnings mandated by SDMC section 24.0907.1. They propose that SDMC section 24.0907.1 be amended to provide for a distribution of surplus earnings between the City, the active membership and the retired members in a manner proportionate to each group's share of assets contained in the corpus of the Trust Fund.

While it would be entirely inappropriate for this office to take any position with respect to the equitable issues raised by the Coalition (claims of unfairness), we have reviewed all the legal issues raised by the group's proposal which include; the voting rights of retired members as set forth in Charter section 143.1, the scope of the administration of the trust fund pursuant to Charter section 145, the guidelines for the Distribution of Earnings and, in particular, the crediting of interest set forth in SDMC 24.0905 and the guidelines for Distribution of Undistributed Earnings set forth in SDMC section 24.0907.1. Each of these points is addressed in turn.

a. Charter section 143.1

Charter section 143.1 requires approval by certain segments of the membership before certain kinds of ordinances can be adopted by the City Council. It provides in pertinent part:

> SEC. 143.1. APPROVAL OF AMENDMENTS BY MEMBERS.
>
> No ordinance amending the retirement system which affects the benefits of any employee under such retirement system shall be adopted without the approval of a majority vote of the members of said system.
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> No ordinance amending the retirement system which affects the vested defined benefits of any retiree of such retirement system shall be adopted without the approval of a majority vote of the affected retirees of said retirement system.

San Diego City Charter section 143.1.

The second paragraph of Charter section 143.1 was added pursuant to the general election held on November 6, 1990, effective February 19, 1991. Thus, as of February 19, 1991, retirees were given the right to vote on any vested defined benefit affecting any retiree under the System.

The Coalition believes that past contributions they have made to the System, which are currently a part of the corpus of the Trust Fund, are being used to effectively subsidize recent benefit improvements for the active members. For that reason, they feel they should be entitled to vote on those benefit changes which they are subsidizing. The fault with this argument lies with the fact that the plain language of Charter section 143.1 clearly implies that the voting rights of retired members hinge upon whether an ordinance change actually affects a vested

retiree benefit in a tangible way.

Assuming for argument's sake that the Coalition theory is valid (we have not been asked, nor are we competent to evaluate the theory from an actuarial perspective), if carried out to its logical conclusion, the retired members would be entitled to vote on all benefits changes, even those benefit changes which have no impact on the level of benefits currently received by retirees. Presumably, the Board debated and endorsed the Charter change three (3) years ago when retirees were given the right to vote. Surely, if the intent of the Charter change was to give retirees broad-based voting rights, with respect to all benefit changes, this would have been accomplished by amending the first paragraph of Charter section 143.1 and not by adding a second paragraph.

In our opinion, a broader application of retiree voting rights as proposed by the Coalition is contrary to the plain language and intent of the 1990 revision to Charter section 143.1. The Charter would need to be amended to accommodate the Coalition's desire for more voting power.

b. Charter section 145

The Coalition believes that the administration of a trust fund under State law imposes upon the Board a fiduciary responsibility to administer that fund in the equitable interest of all members of that trust. As such, they suggest that State law and general fiduciary principles warrant a prorata distribution of the trust's earnings to the City, active members and retirees. We find this proposal problematic for several reasons.

Generally, pension plans create both contractual and trust relationships. They create a contractual relationship between the employer and employees under which the employer contributes retirement benefits to induce continued faithful service by the employees. They also create a trust relationship between pensioners-beneficiaries and the trustees of pension funds who administer retirement benefits.

With respect to the trust relationship, Charter section 145 provides that the retirement funds shall be established as a Trust Fund. In this regard, Retirement Board members are trustees of the CERS trust funds. They are accountable for that degree of financial and official behavior as required by law. Their obligations and duties are the same as any other trustees. Wilson v. Board of Retirement, 167 Cal. App. 2d 229 (1959). As such, they are obliged to use the utmost care to protect trust property and to make the trust productive. Allen v. Hussey, 101 Cal. App. 2d 457, 468 (1950); Cullinan v. Mercantile Trust Co., 80 Cal. App. 377, 385 (1926). In addition, they must exercise their fiduciary responsibilities in good faith and must deal

fairly with the pensioner-beneficiaries. Hittle v. Santa Barbara County Employees Retirement Assn., 39 Cal. 3d 374, 392 (1985); Lix v. Edwards, 82 Cal. App. 3d 573, 578 (1978); Hannon Engineering, Inc. v. Reim, 126 Cal. App. 3d 415, 425 (1981).

Generally, trustees' duties are set forth in the Probate Code at section 15000 et seq. Effective July 1, 1991, this division became known and cited as the Trust law. Although "trusts for the primary purpose of paying debts, dividends, interest, salaries, wages, profits, pensions, or employee benefits of any kind" are expressly excluded from the definition of a trust under the Probate Code section 82(b)(13), Probate Code section 15003(b) makes it clear that the repeal in 1986 of the Civil Code provisions relating to trusts, particularly former Civil Code sections 2215-2244 was not intended to affect general fiduciary principles. Those general fiduciary principles are now set forth at Probate Code section 16000 et seq.

With respect to the contractual relationship, Charter section 144 provides that the Retirement Board "shall be the sole authority and judge under such general ordinances as may be adopted by the Council as to the conditions under which persons may be admitted to benefits of any sort under the retirement system." The statutory scheme indicates that the Retirement Board has broad discretion, under the general ordinances adopted by Council, to administer the retirement system consistent with the fiduciary duties to the system as a whole imposed upon the Retirement Board by State law.

Underlying our concern with the prorata distribution of earnings proposed by the Coalition and central to the Board member's fiduciary obligations as trustees is the concept of vesting. Under well-settled principles of pension law, the California Supreme Court has ruled: "A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity." Betts v. Board of Administration, 21 Cal. 3d 859, 863 (1978).

Importantly, the "employee's contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee's subsequent tenure." Id. at 866. In addition, the "benefits become a part of the vested rights of the employees when conferred." Id. at 867. Finally, "a public employee is entitled only to such compensation as is expressly and specifically provided by law." (Citations omitted.) Longshore v. County of Ventura, 25 Cal. 3d 14, 22-23 (1979).

"The employee's rights are set by the law applicable at the time compensable services are rendered. The Constitution forbids state or local enactments which retroactively grant compensation for work already performed." Id.

Applying the principles of Betts and Longshore, the retirees have vested rights in pension benefits provided by ordinances which were in effect while they were active employees. In turn, they do not have vested rights to benefits which did not exist when they were employed by the City or benefits which were established after their retirement unless there was a specific announced intention to do so.

This framework thus provides clear guidelines for the Board as it exercises its responsibilities to the System, its members and the beneficiaries. The Board administers the Trust Fund while the Council establishes the benefits. In short, there is no authority under the Charter or general trust law to mandate a prorata distribution of the trust fund earnings.

Second, as an additional area of concern, we remind you of a constitutional mandate to minimize employer contributions. According to Article XVI, section 17, "the retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system." In addition:

> The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty. (Emphasis added.)

California Constitution, art. XVI, sec. 17.

Currently, SDMC section 24.0907.1 provides for a credit to the Reserve for Employer Contributions, for the sole and exclusive purpose of reducing retirement system liability, all surplus undistributed earnings remaining after the satisfaction of certain enumerated obligations. As SDMC section 24.0907.1 now provides and assuming further that all benefits presently promised are accounted for and are being delivered promptly, we

find no legal concerns warranting any change in the Board's current procedures. Any proposed modification, however, will require an evaluation of these constitutional considerations.

c. SDMC section 24.0905

SDMC section 24.0905 provides: "The Board shall credit the contribution accounts of members, including safety members, and the City in the Retirement Fund with interest at a rate to be determined by the Board compounded at each June 30th." The Coalition contends that there is nothing in the Board minutes since 1970 indicating that the Board has established this rate after analyzing the impacts on all parties of the Trust.

It is our understanding that the Board reviews the interest assumption rate as a part of the yearly actuarial evaluation. In addition, the Official Minutes reflect that the Board held a special meeting on April 26, 1985, concerning whether it would be appropriate to change actuarial assumptions. As a result of the actuarial study requested and reviewed by the Board at this special meeting, the Board moved to raise interest assumption rate to 8% and the salary inflation factor to 5 1/2%. Before this action, the System operated with an interest assumption rate of 7% and a salary inflation factor of 4 1/2%.

According to the minutes of this meeting, the actuary discussed various economic and actuarial issues that must be considered in choosing from among different sets of assumption. The minutes further indicate that the practical considerations that may influence the selection were discussed by the actuary. Finally, the minutes note that the Board members discussed in detail the actuarial assumptions and cost of living benefit. In light of the foregoing, we find no violations of SDMC section 24.0905 or any fiduciary responsibilities of the Board in this process.

d. SDMC section 24.0907.1

SDMC section 24.0907.1 provides a definition and a framework for the distribution of surplus undistributed earnings. Briefly, surplus undistributed earnings are those sums remaining after interest had been credited to the contribution accounts of the System in accordance with SDMC section 24.0905, the budgeted expenses and costs of operating the System have been paid, sufficient money has been set aside to maintain such reserves as the Board deems appropriate on the advice of its investment counselor and/or actuary and finally after the thirteenth check has been paid to qualified retirees as set forth in SDMC section 24.0404. After these obligations have been met, all remaining sums are credited to the Reserve for Employer Contributions, for the sole and exclusive purpose of reducing retirement system liability.F

Interestingly, as initially enacted, SDMC section 24.0907.1 provided that all remaining sums were to be transferred to an "Advance Reserve Account" to be used solely to reduce the employer contributions to the System. Ordinance No. O-9620, (New Series), effective July 1, 1967.

The Coalition first takes exception to the alleged inequity in SDMC section 24.0404 where some retirees receive thirty dollars ($30) per year for each year of creditable service while others receive forty-five dollars ($45) per year for each year of creditable service. The thirty dollars ($30) and forty-five ($45) caps set forth in SDMC section 24.0404 were the result of the settlement of Andrews v. City of San Diego, Superior Court No. 515699, involving the "13th Check" program described in SDMC sections 24.0907.1 and 24.0404.

As background, we note that prior to 1980 all net Surplus Undistributed Earnings were credited to the Reserve For Employer Contribution to reduce the System's liabilities, pursuant to SDMC section 24.0907.1. In 1980 the City Council, concerned with the double digit inflation affecting retirees, authorized the sharing of the surplus earnings with qualified retirees. Fifty percent (50%) of the surplus was credited to an account to provide monies to pay annual supplemental benefits to qualified retirees. With this action, the "13th Check" was established. See Ordinance No. O-15353 (New Series), adopted on October 6, 1980.

In 1983, following comments made by the Retirement System's actuary, the Board enacted Board Rule 31 which placed a thirty dollar ($30) cap per creditable year of service on the amount of each retiree's annual supplemental benefit. The Board's action was followed by the Andrews lawsuit filed by the retirees and the then currently employed firefighters. The retirees were successful at the trial court. The Board appealed.

Ultimately, the Andrews lawsuit was settled before the resolution of the appeal. As part of the settlement, the Board agreed to establish a 13th check supplemental benefits account for all retirees currently eligible for the benefit. The Board also agreed to increase the Cost of Living Adjustment from 1.5% to 2.0% for all retirees who retired between October 6, 1980, and June 30, 1985. In addition, the Board agreed to pay health insurance premiums for all retirees who retired between October 6, 1980 and January 8, 1982, and for safety members who retired between January 8, 1982 and June 30, 1985. Finally, the Board agreed to include an extra fifteen dollars ($15) per year of creditable service for general member retirees who retired between January 8, 1982 and June 30, 1985. The settlement was ultimately approved by the City Council, the active membership of the System and the Board. In light of the foregoing, we can find

no illegality with the thirty dollars ($30) and forty-five dollars ($45) per year caps currently found in SDMC section 24.0907.1.

Focusing on SDMC section 24.0907.1, the Coalition renews its argument that the surplus undistributed earnings should be distributed between active employees, retirees and the City pursuant to Charter section 143. Although we have previously addressed the Coalition's proposal to redistribute the system's earnings throughout this Memorandum of Law, we highlight comments made by the actuary in the current actuarial evaluation. According to the actuary, the Retirement System operates under a principle of level percent of payroll financing. Under this approach the employer contribution rate will remain approximately level from generation to generation. As further noted by the actuary:

> An inevitable by-product of the level-cost design is the accumulation of reserve assets for decades, and income produced when these assets are invested. Invested assets are a by-product and not the objective.
>
> Investment income becomes the third contributor for benefits to employees, and in interlocked with the contribution amounts required for employees and employer. (Emphasis in original.)

San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1992, pp. 1-2.

Based on our review of Charter section 143, SDMC section 24.0907.1, the state constitution, the actuary's report and other relevant statutory and decisional law, as expressed in this Memorandum of Law, we find no legal mandate warranting a redistribution of surplus undistributed earnings.

Finally, the Coalition suggests that an Independent Public Accountant should be required to certify that undistributed earnings allocations are fully in accordance with the Charter and State law pertaining to Trusts. SDMC section 24.0907.1 does provide that surplus undistributed earnings, for purposes of distributing annual supplemental benefits to qualified retirees (the 13th check), "shall be determined by the City Auditor and Comptroller in accordance with the definition of this section and shall be certified by the City's independent public accountant." This, in fact, occurs. For your information, the Retirement Fund financial statements, in total, are prepared by the auditor and comptroller. In addition, these statements are audited annually

by an independent public accountant.

Question No. 3: I have one additional question about this section of the Code. SDMC Section 24.0907.1 (b) indicates that the balance of earnings after the prior requirements have been satisfied is to be credited to "the Reserve for Employer Contributions, for the sole and exclusive purpose of reducing retirement system liability." I assume that the liability referenced is essentially unfunded liability. My question is what do we do in the event that we have "surplus" undistributed earnings and there is no unfunded liability?

Answer: In the event the System has no unfunded liability, it may be prudent to recommend a change to the SDMC to provide a more appropriate distribution. We remind you, however, of other potential variables in the works. As you are aware, there have been recent discussions concerning the redesign of the City-sponsored post retirement health insurance benefit for eligible retirees. Under one proposal, it has been suggested that this program be brought under the Retirement System. At present, there is an unfunded liability of approximately $200 million and growing associated with this program. In addition, should the City or employees desire a "holiday" from contributions, we remind you of the mandate of "substantially equal" contributions set forth in Charter section 143. Absent any change to this section, any reduction or elimination of contributions must be evaluated in light of this section.

I hope this addresses your concerns. Please let me know if we can provide any additional assistance.

JOHN W. WITT, City Attorney
By
Loraine L. Etherington
Deputy City Attorney

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