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*Certified Specialist Workers' Compensation Law
State Bar of California Board of Legal Specialization

Mr. Alan J. Arrollado
Mr. Raymond G. Ellis
Mr. David A. Hall
PSC Ad Hoc Committee Members
c/o Elaine Reagan, General Counsel
401 West A Street, 4th Floor
San Diego, CA 92101

Re: SDCERS' "Proposed" Answers to Frequently Asked Questions

Dear Messrs. Arrollado, Ellis, Hall:

During the SDCERS' Board meeting on Friday, August 20, 2010, CEO Mark Hovey informed the Board and the public that, with your approval, SDCERS staff intends to post on SDCERS' website a set of "frequently asked questions" ("FAQs") related to PSC issues. He offered two examples of likely FAQs and the "answers."

By e-mail to Mr. Hovey dated August 26, 2010, I repeated a concern which I had already conveyed the same day to Ms. Reagan by telephone, that SDCERS not pose questions and provide answers involving SDCERS' interpretation and application of legal or equitable principles or doctrines to the PSCs at issue when, to do so, creates the potential for SDCERS to become *adverse* to its plan participants on important issues affecting their rights. Avoidance of such an outcome is especially important under the circumstances present here where it was SDCERS' own unnecessary "action" on November 16, 2007, which set in motion the events leading to the present threatened adverse economic action against plan participants causing them understandable anxiety, worry and emotional distress.

As I have previously described, *no further action was necessary* on November 16, 2007, in order for the SDCERS Board to fulfill its fiduciary duty because SDCERS had already filed a declaratory relief action and secured a Superior Court Order on October 16, 2006, that it could lawfully and properly pay all benefits which were being challenged by the City Attorney, including PSCs at rates that were not actuarially neutral. Despite the fact that the SDCERS Board intended by its vote on November 16, 2007, to maintain the *status quo* with regard to PSCs and to take no action *adverse* to any plan participant, the Board's

unnecessary *vote to continue to charge* the City for any UAAL associated with PSCs gave the City the opportunity to raise a timely challenge to the *lawfulness* of this vote and thus the present regrettable situation.

While I do not know what list of “FAQs” and proposed “answers” SDCERS has in mind, I will address the two which Mr. Hovey offered by way of example.

Mr. Hovey’s description of SDCERS’ proposed answer to the first FAQ amounts to a statement of SDCERS’ opinion that, if SDCERS may not permissibly include the underfunding associated with “window period” purchase of service contracts (“PSCs”) in the UAAL to be paid by the City, then the “only” other permissible source is the employees themselves as the contracting parties on these purchase contracts. I have already explained to you at length in my 18-page letter dated August 11, 2010, why I disagree with SDCERS’ assessment/assertion in this regard and I will not repeat the factual and legal analysis which supports my disagreement – except to emphasize that the affected plan participants will have meritorious claims against SDCERS for breach of fiduciary duty and the City will ultimately bear financial responsibility for the damages caused by this breach.

Accordingly, SDCERS has a potential *conflict of interest* with regard to this matter and must not offer misleading advice to plan participants with regard to their rights – including their rights *against SDCERS*. For this reason, if SDCERS intends to present this proposed “FAQ” and answer, I respectfully insist that you also inform the reader that SDCERS is on notice of my disagreement with its answer and offer the reader an optional link to open a copy of my 8/11/10 letter.

The second FAQ and proposed answer which Mr. Hovey described on August 20th is equally troubling due to its unequivocal incorrectness.

Mr. Hovey stated that SDCERS would be informing plan participants that the Fourth District Court of Appeal has concluded that their “window period” purchase of service contracts are unlawful and therefore void. *This is wrong for these reasons:*

(1) After noting that the appeal “actually involves a very narrow issue,” the Court of Appeal held that the Board’s vote on November 16, 2007, to continue to charge the City for the underfunding associated with “window period” PSCs by including it in the system’s UAAL, was *unlawful*.

(2) In reaching this conclusion the Court of Appeal concluded that the Board’s plenary authority did not include the exercise of discretion on August 15, 2003, to establish a “window period” for the purchase of additional service credits at the old rates because statutory law (SDMC section 24.1312) required the Board to charge each employee for the “employer and employee cost of the service credits.”

(a) The Court of Appeal held that employees were not necessary/indispensable parties on the issue before the trial court because the issue was limited to the legality of the Board's decision on November 16, 2007, requiring the City to pay the underfunding associated with these "window period" service credits by adding it to the City's annual bill for the UAL.

(i) In reaching this conclusion, the Court observed that "SDCERS has not asserted that the affected employees have any argument or defense separate or different than that entity." *But, of course, they did.*

(3) The Court of Appeal *did not hold* that any individual "window period" PSC was itself *unlawful* and *void*.

(a) If SDCERS had wanted a determination in this regard in order to avoid the risk of potentially inconsistent judgments, SDCERS had the means – and the obligation as a fiduciary – to bring each affected plan participant before the Court to be "heard" and to become bound by any judgment.

(i) Having failed to bring plan participants into the case, they have not yet been given any opportunity to raise legal and equitable defenses to any attempt by SDCERS to declare their individual PSC contracts void, and/or to bring cross-claims against SDCERS and the City for their fault in the matter.

(ii) SDCERS may not now take adverse action against plan participants which denies them their fundamental due process rights, including the right to raise defenses and present cross-claims.

(4) *Even if* the Court of Appeal's decision means that *some PSC contracts may be void* because the SDCERS Board had no lawful authority under the SDMC to offer these contracts, this would *only be the case if* the price SDCERS charged an individual plan participant for a particular PSC did not represent "the employee and employer cost of that Creditable Service" as required by SDMC section 1312.

(a) Accordingly, if, *but only if*, SDCERS proves, as a threshold matter, that a "window period" PSC for a *particular plan participant* was underpriced by reference to the plan document (i.e., SDMC section 24.1312), would that PSC be arguably *void* – though not necessarily vulnerable to unilateral rescission or modification.

(i) As I already described in my letter dated August 11, 2010, SDCERS' own actuary has conceded that many plan participants paid "too much" for their PSCs and others (a smaller group) paid "too little" when measured against the requirement that ; moreover, Safety Members as a group paid more than a million dollars *too much*.

(ii) And, as I also already noted in my letter dated August 11, 2010, the Court of Appeal correctly observed that the underfunding at issue in the case “may have been avoided entirely if, for example, the retirement fund experienced better than expected investment returns.” Thus, the actual impact of investment earnings must be considered when SDCERS attempts to make its proof that any individual PSC was “underpriced” in violation of the City Charter and the SDMC.

(b) Where SDCERS seeks to have one of its own contracts declared void – a contract which it invited and induced employees to rely upon in planning their finances, careers, and retirements, SDCERS’ *average* pricing methodology will not be an acceptable substitute for actual proof, by a preponderance of the evidence, that this *individual* contract was underpriced in violation of SDMC section 1312.

(c) In the absence of such proof, SDCERS would have no grounds to propose to any individual plan participant that his or her “window period” PSC be declared void and/or that the original terms of the PSC be modified.

(d) Since statutes of limitation apply even to *void* contracts, SDCERS’ successful proof of an underpriced PSC in violation of the SDMC does not mean that SDCERS may avoid the obligations of the contract if its action on the contract is untimely.

(i) Even an allegedly “void” contract *is* subject to a statute of limitations – notwithstanding the argument that a contract made contrary to law is “void” *ab initio*. (*Marin Healthcare District v. Sutter Health* (2002) 103 Cal.App.4th 861.)

(ii) The attached 5-page Memorandum dated January 22, 2004, addressed to the Mayor and City Council by the City’s outside counsel in the *Gleason* litigation confirms that, at some time *before 1/22/04*:

(1) the City was aware that the SDCERS Board had failed to collect a “cost neutral” price for PSCs;

(2) the City was on notice that the Board’s failure to collect a “cost neutral” price for PSCs was arguably a violation of the SDMC; and,

(3) the City was aware that SDCERS had delayed the effective date for increased PSC rates until 11/14/03 such that more than 4,000 new purchase of service requests would be “grandfathered” at the discounted rates.

(iii) The attached Memorandum also confirms that, SDCERS itself was on notice *before 1/22/04* that the City was challenging its decision to “grandfather” PSCs at the discounted rates through November 14, 2003, yet SDCERS invited plan participants

to sign and perform these contracts and, thereafter, to rely to their detriment on their finality, validity, and enforceability when planning their finances and when making crucial, irreversible decisions about their work lives.

Since the City had waived the privilege related to this confidential communication from its outside counsel, this Memorandum was admitted into evidence as Exhibit 1225 on November 8, 2006, during the pension litigation before Judge Barton, with SDCERS' counsel present.

Also admitted into evidence on the same date as Exhibit 1226, is the attached Memorandum dated January 27, 2004, from Assistant City Attorney Les Girard to the Honorable Mayor and City Council stating the office's intent to report on the status of the *Gleason* litigation in closed session; thus, *at least as early as January 2004*, the City Attorney's Office was also fully informed about the PSC issues described in outside counsel's Memorandum dated January 22, 2004, and the legal claims (if any) available to the City at that time.

(e) In addition to any obstacle presented by the statute of limitations, SDCERS must also overcome each plan participant's defense(s) and cross-claims, including claims for SDCERS' breach of fiduciary duty in failing to make a full disclosure to those participants who relied on their fully-performed "window period" PSCs when deciding to sign irrevocable DROP contracts and/or when deciding to retire and forfeit their right to continued employment with the City of San Diego.

(5) As the Court of Appeal also held, SDCERS' "plenary authority" under the California Constitution does not include the right to evade the law. Thus, SDCERS cannot *unilaterally declare* that its "window period" PSCs with two thousand plus plan participants are "unlawful and void" because SDCERS has no *greater* rights than any other contracting party who seeks to avoid the obligations of a contract or otherwise to alter its terms.

(a) SDCERS must *either* get an individual plan participant's voluntary and informed consent (1) to void the PSC if the refund terms are acceptable to the plan participant, or (2) to modify the PSC if the modified terms are acceptable to the plan participant.

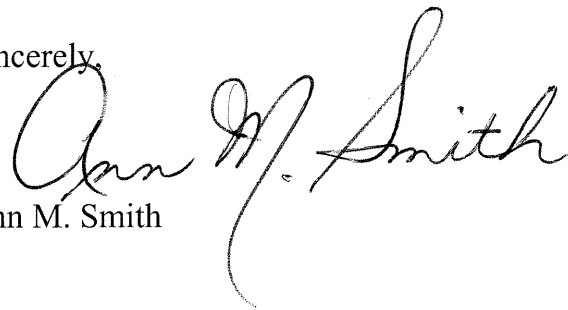
(b) If no voluntary resolution is achieved with the plan participant, SDCERS is duty-bound to seek relief in court just as any other aggrieved party under our rule of law, and, in doing so, must overcome the obstacles presented by the plan participant's defenses and cross-claims.

(6) SDCERS may not use any Voluntary Compliance Program ("VCP") process with the IRS as a "back-door" means to avoid the rule of law and/or to strip plan participants

of their state law rights and remedies – and certainly may not do so where SDCERS is on notice, as it is in this case, that these plan participants have meritorious claims for breach of fiduciary duty *against SDCERS itself* in connection with any attempt to rescind or modify these “window period” PSCs. Because of SDCERS’ actual or perceived *conflict of interest* in this matter, its decision-making with regard to any VCP submittal will require and deserve strict scrutiny.

Accordingly, I respectfully insist that the PSC Ad Hoc Committee direct SDCERS staff to refrain from giving “answers” to plan participants about this controversy which have the potential to mislead them with regard to their rights – including their rights to take action *against SDCERS*. I also respectfully insist that your Committee refrain from formulating recommendations to the Board based on the erroneous assertion/assumption that *any* plan participant’s PSC is *void*, and that the Board itself refrain from authorizing any VCP submittal to the IRS based on such an erroneous assertion/assumption or which, in any manner, deprives each affected plan participant of his or her state law rights and remedies.

Sincerely,

A handwritten signature in cursive script that reads "Ann M. Smith". The signature is written in black ink and is positioned to the right of the typed name.

Ann M. Smith

cc: MEA President Tony Ruiz
MEA General Manager Mike Zucchet
Firefighters Local 145 President Frank DeClercq
SDPOA President Brian Marvel
AFSCME Local 127 President Joan Raymond
DCAA Representative George Schaefer
San Diego Alliance of Unrepresented Employees (AUE)
Retired Employees Association

MEMORANDUM

CONFIDENTIAL & PRIVILEGED
ATTORNEY WORK PRODUCT

→ TO: Honorable Mayor and City Council
City of San Diego

FROM: Timothy R. Pestomik
Luce, Forward, Hamilton & Scripps LLP

SUBJECT: Gleason v. San Diego City Employees' Retirement System and City of San Diego
(San Diego Superior Court Case No. GIC 803779)

→ DATE: January 22, 2004

PLAINTIFF: James F. Gleason and David W. Wood, individually, and on behalf of all others similarly situated

DEFENDANTS: (i) San Diego City Employees' Retirement System, and (ii) the City of San Diego (Individual Retirement System board members were named and served, but dismissed without prejudice.)

SUBJECT MATTER: Plaintiffs allege a continuing violation of the City Charter and San Diego Municipal Code concerning the City's contributions to the retirement fund.

RECOMMENDATION: (i) Continue to defend lawsuit through the summary adjudication phase as explained previously in our May 15, 2003, July 17, 2003, and November 21, 2003 reports; and (ii) allow Bruce Herring to continue to explore settlement opportunities with the plaintiffs and SDCERS.

PROCEDURAL UPDATE

Please refer to our memoranda of May 15, 2003, July 17, 2003, and November 21, 2003 concerning this litigation. This memorandum provides an update on the status of the lawsuit and the status of settlement negotiations.

As previously described, plaintiffs have brought a motion for summary adjudication on their first cause of action against the City of San Diego (the "City"). In this claim, plaintiffs contend that from 1997 forward, the City violated the Charter and the San Diego Municipal Code by failing to contribute the full Actuarially Required Contribution ("ARC") to the San Diego City Employees' Retirement System ("SDCERS"). Plaintiffs' motion for summary adjudication on this claim has

Court's Ex.	1225
Case #	841845
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Clk	JD

1225-0001

been continued once again and will be heard on **February 6, 2004** before the Honorable Patricia Yim Cowett. The City filed its opposition to the motion for summary adjudication on December 5, 2003. Pursuant to stipulation (which continued the hearing to February 6, 2004) Plaintiffs' reply is due January 30, 2004.

As you may recall from our November 21, 2003 memorandum, on September 23, 2003, the court entered an order consolidating the *Gleason* class action lawsuit with two other cases that were filed against SDCERS (and not the City): (1) *Gleason v. San Diego City Employees' Retirement System*, San Diego Superior Court Case No. GIC 810837 ("*Gleason II*"), and (2) *Wiseman v. Board of Administration of the San Diego City Employees' Retirement System*, San Diego Superior Court Case No. GIC 811756 ("*Wiseman*").

In *Gleason II*, the plaintiff seeks to invalidate the November 2002 contract between the City and SDCERS based on allegations that certain SDCERS board members improperly voted to approve the November 2002 contract between the City and SDCERS when those members had a conflict of interest. This case raises claims under Government Code Section 1090 and under the California Political Reform Act.

In *Wiseman*, the plaintiff seeks a judicial declaration that *ex officio* members of the SDCERS Board of Administration, the City Manager and City Auditor, have improperly delegated their duty to serve on the Board to members of their office staff. *Gleason II* and *Wiseman* are also pending before the Honorable Patricia Yim Cowett.

STATUS OF SETTLEMENT NEGOTIATIONS

On-going settlement negotiations have taken place between City representatives (lead by Bruce Herring), SDCERS representatives (lead by Larry Grissom and the independent fiduciary for SDCERS, Nell Hennessey), together with each of their lawyers, and plaintiffs' counsel, Michael Conger. Recently, the settlement process has gotten more difficult as a result of positions taken by SDCERS and its counsel, as described below.

In accordance with concepts discussed at our last closed-session briefing, the City offered to enter into a global settlement of all actions (*Gleason I*, *Gleason II*, and *Wiseman*) on the following general terms:

The City's Settlement Proposal

1. The City would increase its annual contribution to SDCERS over that which it is currently required to pay pursuant to Manager's Proposal II (an agreement between the City and SDCERS). The City would increase its contribution by \$14 million per year for three years until the amount contributed reaches full ARC levels in 2007. (Note: This would represent only \$5 million per year in *new* money since the City would continue to contribute approximately \$9 million of this increased amount through Enterprise Funds, as we did in 2003.)
2. The settlement would be contingent on the SDCERS Board agreeing to reset the amortization schedule on the fund's Unfunded Accrued Actuarial Liability ("UAAL") to a new 30-year fixed term commencing now. The effect of this new amortization schedule (which some

other municipalities are currently utilizing) would be to lower the City's actuarially-calculated payment, similar to refinancing a home mortgage. It does not, however, lower the UAAL.

3. Because the increased payments described above under item 1 would still fall short of the City paying the full ARC that plaintiffs contend the City should pay, the City would provide collateral to SDCERS in the form of a security interest in City-owned real estate.

a. The City-owned real estate would secure the difference between what the City will now pay between 2004 and 2007, when the City reaches the full ARC rate (the "Delta"), and for two years after reaching ARC (until 2009). The amount secured would be approximately \$40-\$45 million.

b. The security would be available to SDCERS as collateral if the City failed to meet any of the required payments between 2004 and 2007 and for two more years after reaching full ARC, or if the City files a municipal bankruptcy. The collateral would be released no later than 2009. In other words, if the City did not pay what it agreed to pay under the new deal, SDCERS could sell the security and apply the proceeds to the Delta. The amount of the Delta that would be subject to the security is *approximately* \$40-45 million (the approximate Delta over three years, 2004 – 2007).

Plaintiffs, through their counsel, Michael Conger, *agreed* to the City's settlement terms, though he did have some suggested additions, none of which would have likely prevented a deal. Specifically, Conger wanted to have SDCERS hold onto the security longer. However, SDCERS' private fiduciary, Nell Hennessey, and their counsel did not agree to the deal. Instead, for the first time after many months of negotiation, they made their own demands of the City.

SDCERS' Fiduciary's Proposal

The new proposal from SDCERS' fiduciary can be summarized as follows:

1. There would be no change from the City's offer to increase its annual contribution by \$14 million (and \$9 million of this could still come from Enterprise Funds).
2. The amortization period would be reset to a 30 years fixed term until it reaches 15 years. Then the amortization period would change to a rolling 15 year amortization period.
3. SDCERS' fiduciary demanded an increase in (i) the amount of the Delta secured, and (ii) the period for which the property would be held as collateral.
 - a. The amount of the Delta to be secured by the City would be increased to approximately \$120 million. Instead of securing the Delta between 2004, (when the settlement is consummated) and 2007 when ARC is reached (three years), SDCERS' fiduciary wanted the City to include as part of the Delta the period beginning three years

prior to the date the lawsuit was filed (i.e., a Delta for the period January 2000 until ARC is reached in 2007).¹

b. The security would not be released for approximately 15 years (instead of 2 years) after reaching ARC. Foreclosure would be triggered by a municipal bankruptcy or a missed payment by the City.

Before responding to the proposal from SDCERS' fiduciary, the City wanted to make sure the SDCERS Board would go along with the fiduciary's proposal if the City did. There would be no point in responding to a proposal from SDCERS' fiduciary if the Board would not agree to it. The City would be negotiating against itself.

The fiduciary and counsel apparently went to the board of SDCERS, and we understand that the SDCERS Board did *not* agree to settle on the fiduciary's proposed terms, nor the City's. The City has asked SDCERS to present a proposal under which they would settle the lawsuits. We have been waiting for a proposal from SDCERS since mid-December. We expect one shortly.

The Purchase of Service Credit Cost Issue and Resulting Losses

Meanwhile, City leaders have taken note of the fact that SDCERS has apparently failed to collect the full cost from employees who elect to participate in the "purchase of service credits" benefit. We have not yet had an opportunity to fully analyze this issue. However, the City believes the Municipal Code requires the SDCERS Board to set the purchase price so that the purchase of service credit would be cost neutral to the retirement system. SDCERS has allowed city employees to contribute at a considerable discount, which results in a significant actuarial loss. Even after recognizing the problem, SDCERS allowed city employees to continue purchasing service credits at a discount, which generated further losses. SDCERS has approved new rates for this program, but they did not take effect until November 14, 2003. Apparently, SDCERS will "grandfather" at the discounted rates those who applied for purchase of service credits prior to this date. This includes more than 4,000 new purchase of service requests.

The total actuarial loss which can be attributed to SDCERS' failure to collect the full cost for the purchase of service credits could be as much as approximately \$180 million if initial estimates from the City are correct, and assuming the 4,000 new applicants are in fact grandfathered. We have not yet had an opportunity to verify these facts. Nevertheless, if true, this loss may even be larger than the City's alleged underfunding of the system. Moreover, we may end up having to argue that, had SDCERS collected the full amount that it should have collected for the purchase of service credits, the City's actuarially computed contribution rate to SDCERS would have been lower. After receiving no response from SDCERS concerning settlement, Bruce Herring raised the purchase of service credit problem to SDCERS in a settlement discussion.

After the City mentioned the purchase of service credit issue to SDCERS, SDCERS' counsel claimed they were all "angry" and reacted by filing (on January 21, 2004) a Notice of Non-

¹ SDCERS would limit the retroactive application of the Delta to three years prior to the date the lawsuit was filed because of the City's detailed argument that the statute of limitations bars any claim for damages or restitution to three years prior to the commencement of the action.

Opposition to plaintiffs' motion for summary adjudication in the *Gleason I* case. SDCERS filed this Notice even though SDCERS had already filed and served a detailed opposition to the plaintiffs' motion for summary adjudication together with written declarations and evidence to oppose the motion (and thereby support the City's position). Therefore, SDCERS' pleadings and evidence are already before the Court, and the City has referred to SDCERS' evidence in the City's opposition. Previously, the City and SDCERS were in agreement on the necessity to defeat plaintiffs' motion for summary adjudication. By filing this new "non-opposition" SDCERS has apparently decided that if we lose the motion, it means more money for the system, and that is good news for SDCERS. It remains to be seen what effect this changed position by SDCERS has on the Court.

We are now working on how to use the issue of the purchase of service credits to the City's advantage if the case does not settle. We will discuss this during the closed session. We understand that the Executive Committee of the SDCERS Board will meet in special session on Monday, January 26. If we learn the results of that meeting, we will update the Council in closed session.

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ATTORNEY TO CLIENT
CORRESPONDENCE

FOR CONFIDENTIAL USE ONLY

Office of
The City Attorney
City of San Diego

01/27/04
ITEM #3

MEMORANDUM

236-6220

DATE: January 27, 2004
TO: Honorable Mayor and Member of the City Council
FROM: Leslie J. Girard, Assistant City Attorney
SUBJECT: *Gleason v. San Diego Employees Retirement System and City of San Diego*
San Diego Superior Court No. GIC 803779

We will report on the status of the above referenced matter in closed session.

LJG:ai

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