CALIFORNIA ASSOCIATION OF PUBLIC RETIREMENT SYSTEMS

ATTORNEYS' ROUND TABLE
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IT'S DEFINITELY NOT SAFE TO GO BACK IN THE WATER
THE NATIONAL TREND IN PENSION LITIGATION

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I. RECENT TRENDS IN PENSION LITIGATION

A. What Happened in the past year?

In 2010 and 2011, a number of states lowered or eliminated cost-of-living provisions in an effort to improve the funding level of financially-stressed retirement systems. The reductions were challenged by members and retirees as impairing the obligation of contract and depriving members of their property rights without due process of law. In a pair of detailed trial court decisions issued in June 2011, courts in Minnesota and Colorado rejected the constitutional challenge. The third challenge in South Dakota met the same fate in 2012.

The Minnesota case, Swanson v. PERA, was decided using an analysis of Minnesota's promissory estoppel theory which calls for a balancing of legitimate state interests and the rights and expectations of retired plan members. In finding that the reduction of the COLA was not unconstitutional, the Court noted that the legislative history of the COLA provisions indicated that it was intended to be a variable and, therefore, amendable provision. At the same time, however, the Court made it clear that the base benefit was not subject to alteration based on constitutional contract and property principles.

Reaching the same result for surprisingly similar reasons, a Colorado trial court rejected a challenge to a Colorado law altering the COLA provisions of the state retirement system. The Court found that the COLA had been an ever-changing process, unlike the base retirement which the Court found to be protected from diminution or impairment.

In the 2011 Legislature, at least 18 states considered similar reductions in COLA benefits alone. The most highly publicized were reductions by the Rhode Island, New Jersey and Florida Legislatures. The New Jersey and Rhode Island provisions are particularly controversial in that it creates a committee to decide if the COLA should be reinstated once the retirement plan meets a certain funding benchmark. Challenges in New Jersey have thus far been unsuccessful, with a federal court refusing to hear constitutional claims because it viewed the matter as an action for damages against a state, which is forbidden by individuals in a federal court under the 11th Amendment of the U.S. Constitution.

In December, 2011, a Florida trial court joined sister courts, Arizona and New Hampshire, in striking down changes to employee contribution rates and reductions in COLAs. The Florida Legislature appealed and the case, *Scott v. Williams*, the case was argued on September 7th, having been "fast tracked" past the middle level appeals court as a question of great public importance. The Florida Retirement System, which lacks an independent board of trustees, is taking no role in the litigation.

In May, a California appellate court upheld dismissal of case which voided a pension benefit which was not enacted in accordance with the City Charter. Because the benefit was not properly enacted, it was held not to create any contract rights and retroactive invalidation of the benefit did not violate the constitutional rights of participants, not did it create a grounds for estoppel and detrimental reliance. *San Diego City Firefighters Local 145 v. Board of Administration, 141 Cal. Rptr. 3d 860 (Cal. App. 2012).*

In mid-August, 2012, the Michigan Court of Appeals in *AFT Michigan v. State*, ___N.W.2d___, 2012 WL 3537789 (Mich. App. 2012), determined that a Michigan law requiring that public school districts withhold 3% of employee wages as an employer contribution was unconstitutional. The court found that the law violated the contracts clause, was a taking of private property without just compensation, and a violation of substantive due process. Essentially, the court held that the employees had a property right in the salary that had been earned which the state wrongly took to pay its own obligations. The state has asked the Michigan Supreme Court to review the matter.

Louisiana Retired Employees Association is currently challenging the recently enacted cash balance tiers of LASERS and TRSL based on the failure of the Legislature to adopt the measures by the constitutionally required 2/3 vote. The issue at litigation will likely address the meaning of "cost" and whether the Legislature may ignore its statutorily-designated auditor's report in favor of an actuarial report which provides the desired result.

B. What's on the horizon?

1. *City of Houston v. Houston Firefighters' Pension Fund*

The City has sued the Board of Trustees to obtain access to membership data to prepare a competing actuarial valuation to support efforts to reduce retirement benefits and close the current defined benefit plan. The Board has refused citing state confidentiality laws. Pending cross motions for summary judgment.

2. *FOP v. City of Miami*

Florida recognizes employee collective bargaining as a fundamental constitutional right. A provision of the state public employee bargaining law allows a unilateral alteration of contract rights when a financially urgent situation exists. Financial urgency is not statutorily defined. Police union challenging both facial and "as applied" constitutionality.

3. *Alabama Suits*

State judges filed a challenge to a 40% increase in employee contributions in state court. City employees in Gadsden filed a comparable suit in federal court.

4. ***Miami Beach pension***

Under the City Charter, a referendum is required to change pension benefits. The City imposed a collective bargaining agreement resulting in adverse changes. The Florida appeals court held that the bargaining law trumped the earlier requirement for a referendum. *City of Miami Beach v. Board of Trustees,* 91 So.3d 237 (Fla. 3d DCA 2012)

5. ***Idaho Education Ass'n v. State***

Challenge filed in state court to repeal of early retirement incentive and shortening of all collective bargaining agreements.

6. ***Cherry v. Baltimore***

Federal suit challenging reduction of benefits for active and retired police and fire. Trial completed in February, 2012; awaiting final judgment.

7. ***Maine Ass'n of Retirees v. Board of Trustees***

Federal suit filed challenging reduction in COLA benefits.

8. ***Ohio pension cases***

Suits filed in both state and federal courts challenging massive reduction in pension and COLA benefits in Cincinnati.

9. ***Rhode Island Retirees Ass'n v. Chaffee***

State court challenge filed to reductions on final average salary, extended retirement age, suspension of COLA and movement of current workers to hybrid plan.

10. ***Duncan v. TVA Retirement System***

Federal court challenge fired to pension accumulation.

11. *Texas Pension reform - Second Battle of the Alamo*

Texas legislators and municipal officials have vowed to take decisive action to cut retirement benefits. DROP and benefit spiking are key issues. Likely to bring first interpretation of 2003 constitutional guarantee of vested benefits provision in Article XVI, Section 66 of State Constitution.

II. THE DUTY OF TRUSTEES IN PLAN DESIGN DISCUSSIONS

A. What is not the trustees fight?

Trustees do not have a constituency of management or labor. Their sole constituency is the best interest of the members and beneficiaries of the System. Collective bargaining is a matter between employee organizations and employers. Trustees of a retirement system have no role in that process. Whether benefits should be increased or decreased is a matter between the participants and the state.

B. What is the trustees fight?

The general body of state law governing public employee pension funds is clear that fiduciaries have a duty to protect the system for the benefit of the members and beneficiaries. Changes which would weaken the financial status of the system or interfere with its efficient administration are the responsibilities of the trustees to challenge. As always, the timely collection of contributions is a primary duty. The efficient investment of system assets is also a responsibility which the trustees must safeguard. Plan design changes which will result in adverse financial consequences to the system give rise to a duty on the part of trustees to report those potential adverse consequences to the Legislature and to advocate for their elimination.

C. Pitfalls for the Unwary

Increasingly, matters traditionally within the control of fiduciaries such as actuarial funding methods and assumptions are becoming traded commodities at the collective bargaining table. Employers struggling with rising retirement costs and unions pressured by members for immediate economic benefits have been frequently including adoption of certain funding decisions in collective bargaining agreements as a requirement to implement wage increases.

Without the Board's concurrence, those contract provisions do not become effective. This places inordinate pressure on trustees to temper wise actuarial and investment policy decisions with the political wishes of both the membership and the plan sponsor. This points to the continued validity in the admonition that pension boards should have no role in collective bargaining.

D. Why So Many COLA Cases?

In many instances COLA benefits are variable. The formulae have been altered over time, apparently without universal objection. In many instances a lower fixed rate COLA is substituted for a variable COLA as a constitutionally acceptable trade of a guaranteed "something" for a chance at a bigger "nothing." See, *Claypool v. Wilson*, 6 Cal. Rptr.2d 77 (Cal. App. 1992).

III. CURRENT CHALLENGES TO TRUSTEES

A. Investment Losses

Claims in Texas were successfully defeated in suits by members over large investment losses arising out of the market down turn in 2008. Courts in those states found that members lacked standing to bring claims as defined benefit participants are not direct owners of system assets. Given trends to cut benefits directly because of losses in investment may give a new life to such claims in the future. See, *Ramon v. Teachers' Retirement System of Texas,* 2010 WL 1241293 (Tex. App. 2010)

Similarly, New Mexico teachers were held to lack standing to recover 2008 investment losses. During the national economic crisis in 2007-2008, the New Mexico Educational Fund ("Fund") lost approximately $40 million on certain private equity investments. The Fund holds approximately $8.5 billion in assets used to pay benefits for 95,000 teachers and other participants. Teachers brought suit against the fund, board members and investment advisers for breach of fiduciary duty, violation of federal and state securities laws, aiding and abetting breach of fiduciary duty, and breach of contract. Plaintiffs alleged that they were injured by defendants' improper investments due to potential increased employee contributions, reduced services, tax increases, and the increased risk that the fund would not have sufficient assets to satisfy its obligations in the future. The court held that plaintiffs could not show that their benefits were threatened, that the system was currently underfunded, or that the challenged investment caused the underfunding.

The court recognized that altering retirement eligibility or contribution requirements would require the Legislature to act. Under these circumstances, plaintiffs lacked standing to sue. Plaintiffs' allegations that they faced the risk of tax increases, potential future benefit reductions or increased contribution levels, and that they were injured by the loss of principal, income, fees, and expenses did not establish an injury in fact fairly traceable to the defendants.

State governmental entities, including public employees/trustees acting within the scope of their duties, are immune from liability for any tort, except as waived by law. The court held that breach of fiduciary duty is not one of the tort claims for which the New Mexico Legislature chose to waive governmental immunity under New Mexico's Tort Claims Act. After granting the motion to dismiss in part, the federal district court remanded the case to New Mexico state court given a lack of subject matter jurisdiction.

Hill v. Vanderbilt Capital Advisors, 2011 WL 6013025 (D.N.M 2011)

B. Recent venue disputes in investment cases.

1. The choice of venue and applicable law has become of increased importance in an increasing number of suits arising from events connected with the capital market decline in 2008. In a pair of recent cases, the issue of state versus federal court as the proper forum was decided with diametrically opposed results.

   In *General Retirement System of the City of Detroit v. UBS*, 2010 WL 5296957 (E.D. Mich. 2010), the retirement system sued UBS alleging that the latter fraudulently induced both the general and public safety pension funds into buying an equity position in collateralized loan obligations and for breach of fiduciary duty. The suit was filed in Wayne County, Michigan state court. UBS removed the case to federal court on the basis of diversity of citizenship. The retirement plans sought to remand the cases back to state court claiming that each had retiree participants residing in Delaware and Connecticut. The federal court declined to remand the case finding that the residency of the pension funds, as the legal owners of the assets, controlled rather than the citizenship of individual participants.

By contrast, in May 2011, the United States Court of Appeals for the 8th Circuit remanded a securities fraud case back to state court in *Public School Retirement System v. State Street Bank and Trust*, 640 F.3d 821 (8th Cir. 2011). As State Street was a citizen of Massachusetts, it removed the case to federal court from the state court in Cole County, Missouri, the county where the retirement plan was headquartered. The retirement plan moved to remand the case back to state court claiming it was immune under the diversity of citizenship statute. The appeals court found that the retirement plan was an arm of the State of Missouri. As such, the system was not a "citizen" within the definition of the federal law providing for jurisdiction between citizens of different states. Apparently, the deciding factor was the state treasury's exposure to costs of the retirement system.

2. Court refuses to dismiss securities lending claims since factual questions exist, including whether warning signs should have caused a reasonably prudent fiduciary standing in Northern Trust's shoes to act differently.

The Louisiana Firefighters' Retirement System, the Public School Teachers' Pension & Retirement Fund of Chicago and other lead plaintiffs brought a class action suit against Northern Trust alleging breach of fiduciary duties and breach of contract arising out of Northern Trust's securities lending program. Through that program, Northern Trust arranged loans of securities owned by its customers to pre-approved borrowers. Borrowers pledged collateral equal to 102% of the market value of the loaned securities. Northern Trust then invested in fixed-income securities, generating revenue for the participants in the program. Plaintiffs claimed that Northern Trust, in pursuit of higher lending fees and in breach of fiduciary and contractual duties, ignored the investment objectives of the Collateral Pools and imprudently invested hundreds of millions of dollars in exotic, unregistered securities, such as structural investment vehicles ("SIVs"). Plaintiffs alleged that these and other securities were inappropriately long term and high risk and therefore unsuitable to properly serve as short term collateral. For example, by mid–2007 more than half of the securities in the Short Term Extendable Portfolio ("STEP") Collateral Pool were not due to mature for at least two years, and 18% of those securities were not due to mature for at least 20 years. At the height of the financial crisis in October 2008, a third of the securities in the Core USA Collateral Pool were not due to mature for over two years.

Because they carried greater risk, the longer-term securities yielded higher returns. This provided Northern with enhanced securities lending fees which exceeded the fees that would have been earned on shorter-term notes. Plaintiffs further alleged that the Collateral Pools were inappropriately structured with high levels of exposure to the housing market.

According to the complaint, Northern ignored warning signs, including warnings by its own Chief Economist that a housing bubble and recession would severely impact the United States banking industry because of unprecedented exposure to housing loans. Northern argued that it took appropriate steps following the bankruptcy of Lehman Brothers in 2008, which triggered a financial crisis. Northern also argued that the investment guidelines for the pools expressly allowed these types of investments.

The court refused to dismiss the case, recognizing that "the fact that a pool's guidelines would allow a type of investment does not per se indicate that such an investment would be prudent given a particular set of financial circumstances." As the lawsuit progresses to summary judgment or trial, plaintiffs will need to establish that warning signs would have caused a reasonably prudent fiduciary to act differently. The court held nonetheless that plaintiffs' claim for breach of good faith and fair dealing was properly dismissed since it was subsumed in plaintiffs' breach of contract claim.

Louisiana Firefighters' Retirement System v. Northern Trust Investments, **2011 WL 1770266 (N.D.Ill. 2011)**

3. In continuation of securities lending litigation case, federal district court dismisses third party complaint and all 31 affirmative defenses, refusing to permit "blame the victim" defensive strategy.

This case is the continuation of the ongoing class action against Northern Trust for breach of fiduciary duty involving securities lending losses. After the court denied Northern Trust's motion to dismiss, Northern raised 31 separate affirmative defenses with its answer. Northern also brought a third-party complaint asserting claims for contribution and indemnification against plaintiff boards. The boards moved to dismiss on a number of grounds, including that Northern's claims were not properly brought in a third-party complaint, and that neither indemnification nor contribution is available for claims of breach of fiduciary duty.

Northern Trust asserted that if plaintiffs are right that the collateral investment strategies were imprudent, then plaintiffs bear sole responsibility "because they made the *choice* to accept a certain level of risk in return for the potential investment rewards." The boards successfully argued that defendants' third-party complaint pursues a "blame the victim strategy." Northern Trust was essentially alleging that if it is liable to plaintiffs for imprudently investing, then the boards are more liable for hiring Northern and not stopping it from breaching its fiduciary duty. The court determined that these purported third party claims by Northern were defenses, not third party claims. According to the court, if Northern was found liable to plaintiffs, it can be based only on Northern's own breaches of fiduciary duties, not on any legal principle that makes it liable for the boards' actions. Northern can be liable to plaintiffs based only on its own guilt. Because it cannot be both blameless and liable, Northern could not claim for implied indemnity.

With regard to the 31 affirmative defenses raised by Northern Trust, the court applied a three-part test. None of the affirmative defenses presented any factual predicate and were simply conclusory allegations. Accordingly, the court dismissed Northern's third-party complaint and granted the plaintiffs' motion to strike all 31 of Northern's affirmative defenses.

Louisiana Firefighters' Retirement System v. Northern Trust Investments, 2012 WL 601861 (N.D.Ill. 2012)

4. Breach of fiduciary duty claim against investment consultant is not subject to dismissal based on Florida's economic loss rule.

Three pension boards in the City of Lake Worth Florida brought a class action lawsuit against Merrill Lynch arising out of an SEC investigation of conflicts of interest and inadequate disclosure. The suit alleged a single count for breach of fiduciary duty. Plaintiffs asserted that Merrill sought and created a relationship of trust and confidence while serving as a gatekeeper. The complaint alleged that Merrill breached its duties by acting in its own interest and for its own benefit, using plan assets for its own profit without adequate disclosure.

Merrill moved to dismiss, arguing that the claim was barred by the economic loss rule, as it arises out of, or is intertwined with, a series of contracts between plaintiffs and Merrill Lynch. According to Merrill, the claim for breach of fiduciary duty is a camouflaged breach of contract claim. Merrill Lynch argued that regardless of how plaintiffs labeled their claim as one for breach of fiduciary duty, the duties Merrill Lynch allegedly failed to perform arose from, and are inextricably intertwined with, the obligations outlined in the parties' written agreements. The plaintiffs responded that Merrill Lynch's fiduciary duties existed separate and apart from the parties' contracts and that the mere existence of a contract does not immunize Merrill or provide a free pass to cavalierly repudiate its fiduciary duties and enrich itself through self-dealing at the expense of the class.

The economic loss rule is a judicially-created doctrine that sets forth the circumstances under which a tort action is prohibited if the only damages suffered are economic losses. The rule applies when the parties are in contractual privity and one party seeks to recover damages in tort for matters arising out of the contract. The rule is designed to prevent parties to a contract from circumventing the allocation of losses set forth in the contract by bringing an action for economic loss in tort.

Nevertheless, where the duties breached do not arise under the contract, an action for an independent tort may exist even though the parties are in contractual privity. Accepting all factual allegations in the complaint as true and construing them in the light most favorable to plaintiffs, the court held that the complaint alleged facts which are distinct from a breach of contract claim. At this stage in the case, the court determined that the claim was both adequately pled and not barred by the economic loss rule. To the extent that discovery demonstrated that the duties allegedly breached by Merrill Lynch are in fact based on or inextricably intertwined with the parties' written agreements, the court indicted that it would revisit the issue. Ultimately the case settled.

Board of Trustees of the City of Lake Worth Employees' Retirement System v. Merrill Lynch Pierce Fenner & Smith, **2011 WL 2144658 (M.D.Fla. 2011)**

C. Financial Emergency Laws/Bankruptcy

Bankruptcy proceedings continue in Alabama by the City of Prichard seeking to avoid its failure to fund its retirement system. The bankruptcy court in Central Falls, Rhode Island approved an agreement by retirees to take diminished retirement benefits. Bankruptcies in Vallejo and Stockton have yet to implicate retirement benefits. As a result, bond holders, who were made whole in the Central Fall, Rhode Island bankruptcy did not fare well in California. The "push back" from the bond insurers is the next likely legal battleground.

Florida courts are currently considering a challenge to the state financial urgency law which purportedly allows a city, on 14 days' notice, to alter terms of employment including pension benefits. In none of these cases has a pension board of trustees acted as an advocate for plan participants.

D. Liability Limitations Sought by System Providers.

A retirement system was found not to be contributorily negligent in the oversight of its actuary and the actuary was liable for $72,000,000 in lost contributions and lost interest**.**

Milliman was hired in 1982 to provide actuarial valuations for each of Maryland's state systems. In 2004, Milliman discovered a longstanding coding error during a replication audit. Milliman's calculations treated code "00" as meaning only a straight life annuity, even though code "00" also included 50% survivor spouse benefits. The State Board of Contract Appeals determined that Milliman had breached its contract to provide actuarial services. The system was awarded $34 million in lost contributions and $38 million in lost interest on those contributions. Milliman appealed arguing that the system was not damaged insofar as the taxpayers would fund any deficiency. Milliman also argued that the system was not harmed because notwithstanding the 22 years of actuarial errors, ultimately the system would become fully funded. The lower court determined that this perspective "subverts the entire function and purpose of actuarial analysis, which is to determine how much to contribute and when." If Milliman's arguments were accepted, it could satisfy its contractual obligations by training a monkey to punch random keys on a calculator. The Maryland Court of Appeals, the highest court in the state, agreed. It rejected Milliman's argument that the state retained the use of the contributions, which were not deposited into the system.

The Court refused to recognize an offset, finding that the state and system are distinct entities.

According to the Court, to the extent that the data coding may have been confusing, the actuary bore an express duty to solicit further clarifying information until it accurately understood the information provided by the system. The court credited the testimony of a third-party actuarial expert, witnesses, and trustees that the system had suffered losses and was underfunded as a result of the errors.

On the voluminous records, the court held that substantial evidence supported the lower court's findings that Milliman repeatedly misinterpreted a data code associated with survivors' benefits. The system was not negligent in the development or transmission of the data. As a result, Milliman was fully liable and contributory negligence was not a bar to recovery. *Milliman, Inc. v. Maryland State Retirement and Pension System*, 25 A.3d 988 (Md. 2011).

This decision, coupled with an even larger settlement in Alaska by Mercer Actuaries and numerous suits against asset managers and custodial banks has led to an increased pressure by outside vendors to limit their liability. Given the duty of fiduciaries to safeguard system assets, such limitations may be a questionable exercise of discretion.

E. Governmental Plans and Public Private Partnerships

The current IRS inquiry into the status of "governmental plans has created great uncertainty for private-public partnerships in charter schools, hospitals, utility cooperatives, and similar governmental and quasi governmental partnerships. The IRS completed its hearings in July, 2012. A loss of coverage possesses a number of issues for trustees:

1. Plan population decline
2. Withdrawal liability - who pays the UAAL?
3. State constitutional benefit and contract guarantees
4. Asset ownership.
5. Could a mixed population plan end up subject to ERISA?

VI. CONCLUSION

IF YOU HAVE ANY QUESTIONS OR COMMENTS CONCERNING THIS PRESENTATION, CONTACT ROBERT D. KLAUSNER, ESQUIRE, KLAUSNER, KAUFMAN, JENSEN & LEVINSON, 10059 NW 1ST COURT, PLANTATION, FLORIDA 33324, (954) 916-1202, FAX (954) 916-1232, EMAIL bob@robertdklausner.com, WEBSITE: www.robertdklausner.com