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10 SUPERIOR COURT OF THE STATE OF CALIFORNIA
11 FOR THE COUNTY OF STANISLAUS

12 MICHAEL R. O'NEAL, RHONDA)
13 BIESEMEIER, and DENNIS J.)
14 NASRAWI,)

15 Plaintiffs,)

16 v.)

17 STANISLAUS COUNTY EMPLOYEES')
18 RETIREMENT ASSOCIATION, and)
19 DOES 1-30,)

20 Defendants.)

CASE NO: 648469
PLAINTIFFS' TRIAL BRIEF
Judge: Hon. Robert F. Moody
(Ret.)
Dept: 24
Complaint Filed: November 30, 2009
Trial Date: May 22, 2018

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1 **I. INTRODUCTION**

2 This is an action for breach of fiduciary duties of loyalty and prudence brought by the
3 plaintiffs, three beneficiaries of a public pension trust fund, against the trustee of their of pension
4 trust, defendant Stanislaus County Employees' Retirement Association (StanCERA¹).

5 In Section II, *post*, we will explain (1) the fiduciary duties imposed on StanCERA by
6 section 17 of article XVI of the California Constitution, as amended by The California Pension
7 Protection Act of 1992, (2) the elements of the pleaded causes of action, and (3) the plaintiffs'
8 burden of proof. It is important for the court to have that legal framework firmly in mind before
9 considering the evidence. We will also explain that StanCERA's oft-repeated statement that its
10 decisions are entitled to deference, or that it has discretion to act as it did, have been soundly
11 rejected by the Court of Appeal. The opinion of the appellate court establishes the law of the
12 case.

13 In Section III, *post*, we will set forth the material facts to be shown by the evidence. There
14 is no dispute that StanCERA owes fiduciary duties of loyalty and prudence in its management of
15 the trust fund. Those duties are conceded by StanCERA. The pivotal, disputed issue is whether
16 those duties were breached by five distinct actions taken by StanCERA between 2009 and 2011.
17 The plaintiffs believe that the historical facts will also not be disputed.

18 The plaintiffs' expert, William Sheffler, a licensed actuary and a former trustee of another
19 public pension trust when it was severely underfunded, will explain why StanCERA's actions
20 breached StanCERA's duty of loyalty because StanCERA put the interests of intervenor County
21 of Stanislaus (County)—in balancing its annual municipal budgets—above the interests of the
22 pension trust's beneficiaries. Mr. Sheffler will also explain why StanCERA's actions were
23 actuarially unsound, because they deprived a severely underfunded pension plan of sorely
24 needed, timely contributions and investment earnings on those contributions, the primary
25 lifeblood of a defined benefit plan. Based on his actual experience as a trustee from his years
26

27 ¹ StanCERA is managed by a nine-member Board of Retirement. For convenience,
28 the terms "StanCERA," "retirement board," "board of retirement, and "trustees" will be used interchangeably.

1 correcting similar mistakes by a public pension plan, Mr. Sheffler will also explain why
2 StanCERA's actions were imprudent.

3 In Section IV, *post*, we will demonstrate that StanCERA's decisions in three consecutive
4 fiscal years to use a total of \$45.7 million in trust fund assets to offset actuarially required,
5 annual, employer contributions were breaches of its fiduciary duties of loyalty and prudence.

6 In Section V, *post*, we will demonstrate that StanCERA's decision to adopt a schedule of
7 *negative* amortization of its unfunded actuarial liability (which further reduced the County's
8 annual employer contributions) was a breach of its fiduciary duties of loyalty and prudence.

9 And in Section VI, *post*, we will demonstrate that StanCERA breached its fiduciary duties
10 of loyalty and prudence by transferring \$50 million of non-valuation reserves to valuation
11 reserves (which further reduced the County's annual employer contributions) and adopting
12 policies effectively precluding the payment of ancillary cost-of-living and health benefits to
13 retired members.

14 From the broadest perspective, the evidence will show that the retirement board of
15 StanCERA *repeatedly* put the interests of the County above the interests of the member
16 beneficiaries of the trust fund. At the County's request, StanCERA implemented unlawful
17 "pension raids" by the County, and the County benefitted over \$100 million from StanCERA's
18 breaches of its fiduciary duties.²

19 The *prevention* of pension raids by public employers was the *specific purpose* of the
20 People of California when they amended the California Constitution by enacting The California
21 Public Pension Protection Act of 1992. (Section II(B), *post*.)

22 The enforcement of constitutional rights is this court's greatest responsibility and duty.

23 ///

24 ///

26 ² When there has been a breach of trust, the court has a duty under trust law to
27 remediate the harm caused by the breach, i.e., to put the trust in the position it would have been
28 in but for the trustee's breach. Because the trial has been bifurcated, the proper injunctive
remedies will not be addressed in this brief on liability.

1 **II. STATEMENT OF APPLICABLE LAW**

2 **A. StanCERA Owes Constitutional, Fiduciary Duties of *Loyalty* and**
3 ***Prudence* to the Plaintiffs, Who Are Beneficiaries of the Pension**
4 **Trust Fund.**

5 The ultimate source of StanCERA’s duties to the plaintiffs is section 17 (“section 17”) of
6 article XVI of the California Constitution, which governs all state public pension retirement
7 systems. For the court’s convenience, a copy of section 17 is attached as Exhibit A.

8 StanCERA owes a paramount, *fiduciary* duty of *loyalty* to its members.

9 Subdivision (a) of section 17 provides in part: “The retirement board of a public pension
10 or retirement system shall have the sole and exclusive *fiduciary* responsibility over the assets of
11 the public pension or retirement system. The retirement board shall also have sole and exclusive
12 responsibility to administer the system in a manner that will assure prompt delivery of *benefits*
13 and related services to the participants and their beneficiaries. The assets of a public pension or
14 retirement system are *trust funds* and shall be held for the *exclusive* purposes of [1] *providing*
15 *benefits to participants* in the pension or retirement system and their beneficiaries and [2]
16 defraying reasonable expenses of administering the system.” (Italics added; *O’Neal v. Stanislaus*
17 *County Employees’ Retirement Association* (2017) 8 Cal.App.5th 1184, 1201 (“*O’Neal II*”).³)

18 Subdivision (b) of section 17 provides: “The members of the retirement board of a public
19 pension or retirement system shall discharge their duties with respect to the system solely in the
20 interest of, and for the exclusive purposes of providing benefits to, participants and their
21 beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of
22 administering the system. *A retirement board’s duty to its participants and their beneficiaries*
23 *shall take precedence over any other duty.*” (Italics added; *O’Neal II, supra*, 8 Cal.App.5th at p.
24 1201.)

25 Subdivision (c) of section 17 imposes a duty of *prudence* on public pension retirement
26 boards: “The members of the retirement board of a public pension or retirement system shall
27 discharge their duties with respect to the system with the care, skill, prudence, and diligence

28 ³ The 2017 published decision in *O’Neal II* is attached at Exhibit B.

1 under the circumstances then prevailing that a prudent person acting in a like capacity and
2 familiar with these matters would use in the conduct of an enterprise of a like character and with
3 like aims.” (*O’Neal II, supra*, 8 Cal.App.5th at p. 1202.)

4 Subdivision (e) of section 17 provides: “The retirement board of a public pension or
5 retirement system, *consistent with the exclusive fiduciary responsibilities vested in it*, shall have
6 the sole and exclusive power to provide for actuarial services *in order to assure the competency*
7 *of the assets of the public pension or retirement system.*” (Italics added.) In other words, a
8 retirement board has the power to provide for actuarial services in order to perform its fiduciary
9 duty to assure that the assets of the system are sufficient to pay the “vested” pension benefits
10 promised to all members and to provide statutorily authorized, ancillary, cost-of-living and health
11 “benefits” (§ 17, subd. (a)) to retired members. It may *not* constitutionally use its actuarial power
12 to deliberately *underfund* the system.

13
14 **B. In 1992 the People of California Amended the State Constitution To
Prevent Public Entities from Raiding Public Pension Trust Funds.**

15 The California Pension Protection Act of 1992 (the “Act”) was adopted by the People as
16 Proposition 162. It amended the provisions of the California Constitution governing the
17 administration of public pension systems. Because an understanding of the Act is crucial to an
18 understanding of the basis for these consolidated lawsuits, the plaintiffs have requested the court
19 to take judicial notice of the ballot materials that informed the electorate.⁴

20 As a general rule, when courts interpret a statute or constitution, they attempt to
21 determine legislative intent so as to effectuate the purpose of the law. (*Burden v. Snowden* (1992)
22 2 Cal.4th 556, 562.) The courts first read the legislative provision, and do so in an ordinary way
23 unless special definitions are provided. (*Hayward Area Planning Assn. v. Alameda County*
24 *Transportation Authority* (1999) 72 Cal.App.4th 95, 104-105; *Professional Engineers v. Wilson*
25 (1998) 61 Cal.App.4th 1013, 1019-1020.) If the meaning of the words is clear, then the language

26
27 ⁴ Opposition to that request is not expected. Such judicial notice has previously
28 been taken in this case, without opposition from the defendants, by this court and the Court of
Appeal.

1 controls. (*Hayward Area Planning Assn., supra; Professional Engineers, supra.*) But if the
2 meaning of the words is not clear, courts can use interpretive aids. (*Hayward Area Planning*
3 *Assn., supra; Professional Engineers, supra.*)

4 With respect to voter-approved enactments, the interpretive aids include “the ballot
5 analysis, the official summary, and the arguments presented to the voters.” (*Hayward Area*
6 *Planning Assn., supra*, 72 Cal.App.4th at p. 105; *Professional Engineers, supra*, 61 Cal.App.4th
7 at p. 1020.) “California decisions have long recognized the propriety of resorting to such election
8 brochure arguments as an aid in construing legislative measures and constitutional amendments
9 adopted pursuant to a vote of the people. [Citations.]” (*White v. Davis* (1975) 13 Cal.3d 757,
10 775, fn. 11.) Such ballot materials represent “the only [available] ‘legislative history’” of a
11 constitutional amendment adopted by vote of the people. (*Id.* at p. 775.) The ballot pamphlet was
12 the *only* document that was before all of the voters.

13 The purposes of the People are especially relevant to the claims of breach of fiduciary
14 duty made by the plaintiffs in this case. (*O’Neal II, supra*, 8 Cal.App.5th at p. 1203.)

15 *First*, the intent and broad purpose of the People in enacting the California Pension
16 Protection Act of 1992 is shown from its text. Section Two includes “Findings and
17 Declarations” explaining the need for Proposition 162:

18 Section Two. Findings and Declarations. The People of the State of California
19 hereby find and declare as follows:

20 (a) Retired citizens depend upon their pension benefits to meet basic necessities
21 such as food and shelter during their retirement years. For many elderly citizens
22 who are not eligible to participate in Social Security, pension benefits are their
23 sole source of financial support and security.

24 (b) Teachers, firefighters, police officers and other local, school and state
25 employees depend on promised pension benefits, which must be protected from
26 political abuse and misappropriation.

27 (c) *Politicians have undermined the dignity and security of all citizens who*
28 *depend on pension benefits for their retirement by repeatedly raiding their*
pension funds.

(d) Political meddling has driven the federal Social Security system to the brink
of bankruptcy. To protect the financial security of retired Californians, politicians
must be prevented from meddling in or looting pension funds.

(e) *Raids by politicians on public pension funds will burden taxpayers with*

1 *massive tax increases in the future.*

2 (f) *To protect pension systems, retirement board trustees must be free from*
3 *political meddling and intimidation.*

4 (g) The integrity of our public pension systems demands that safeguards be
5 instituted to prevent political “packing” of retirement boards, and encroachment
6 upon the sole and exclusive fiduciary powers or infringement upon the actuarial
7 duties of those retirement boards.

8 (h) In order to protect pension benefits and to avoid the prospect of higher taxes,
9 the People must act now to shield the pension funds of this state from abuse,
10 plunder and political corruption.

11 (Italics added.)

12 Section Three includes a statement of the People’s “Purpose and Intent” in enacting the
13 California Pension Protection Act of 1992:

14 Section Three. Purpose and Intent. The People of the State of California hereby
15 declare that their purpose and intent in enacting this measure is as follows:

16 (a) *To protect pension funds so that retirees and employees will continue to be*
17 *able to enjoy a basic level of dignity and security in their retirement years.*

18 (b) To give voters the right to approve changes in the composition of retirement
19 boards containing elected retirees or employee members.

20 (c) *To protect the taxpayers of this state against future tax increases which will*
21 *be required if state and local politicians are permitted to divert public pension*
22 *funds to other uses.*

23 (d) *To ensure that the assets of public pension systems are used exclusively for*
24 *the purpose of efficiently and promptly providing benefits and services to*
25 *participants of these systems, and not for other purposes.*

26 (e) To give the sole and exclusive power over the management and investment of
27 public pension funds to the retirement boards elected or appointed for that
28 purpose, to strictly limit the Legislature’s power over such funds, and *to prohibit*
29 *the Governor or any executive or legislative body of any political subdivision of*
30 *this state from tampering with public pension funds.*

31 (f) To ensure that all actuarial determinations necessary to safeguard the
32 competency of public pension funds are made under the sole and exclusive
33 direction of the responsible retirement boards.

34 (g) *To affirm the legal principle that a retirement board’s duty to its participants*
35 *and their beneficiaries takes precedence over any other duty.*

36 (Italics added.)

37 Section Five provides an express rule of liberal interpretation: “The provisions of this act
38 shall be liberally interpreted to effect their purposes.”

1 The available interpretative aids—the ballot analysis, the official summary, and the
2 arguments—show that the central purpose of Proposition 162 was *to prevent governmental*
3 *entities from raiding pension trust funds.*

4 As the Court of Appeal held in *Westly v. Board of Administration* (2003) 105 Cal.App.4th
5 1095, 1111: “In keeping with the foregoing” findings, declarations, and statements of purpose
6 and intent, “*the thrust of the ballot arguments in favor of [a]rticle XVI, section 17[,] is to*
7 *prevent the Legislature [and local governmental entities] from ‘raiding’ pension funds.*” (Italics
8 added.) “The summary argument in favor states that [a]rticle XVI, section 17[,] would ‘stop
9 politicians from raiding the pensions of . . . public employees.’ [Citation.] The claims address
10 the means by which the Legislature on previous occasions had altered its contributions to the
11 retirement system. [¶] The full argument in favor of the initiative warns that politicians would
12 continue to raid the pension funds of retirees unless [a]rticle XVI, section 17[,] was passed. It
13 complains it was ‘not right’ to allow politicians to ‘balance their budgets on the backs of seniors
14 and retirees.’ [Citation.] [¶] The rebuttal argument states the proposition’s opponents are
15 ‘trying to mislead the voters.’ ‘The central purpose of this measure is to STOP POLITICIANS
16 FROM USING PUBLIC PENSION FUNDS TO BAIL THEM OUT WHEN THEY FAIL TO
17 KEEP GOVERNMENT SPENDING UNDER CONTROL.’ [Citation.]” (*Ibid.*)

18 In short, the California Pension Protection Act of 1992 was intended to prevent public
19 pension systems from being administered for the benefit of public employers rather than the
20 employee beneficiaries. It must be liberally construed to accomplish that purpose.

21 **C. StanCERA Owes No Fiduciary Duty to the County.**

22 The defendants have never contended that StanCERA owes a fiduciary duty to the
23 County. It does not. Neither the California Constitution nor the County Employees Retirement
24 Law (“CERL”) imposes any duty on retirement boards—fiduciary or otherwise—to administer
25 pension trusts for the benefit of public employers. As the court discussed in *O’Neal II*: “‘In light
26 of the controlling duty of loyalty, ‘a “fiduciary cannot contend ‘that although he had conflicting
27 interest, he served his masters equally well or that his primary loyalty was not weakened by the
28 pull of his secondary one.’” [Citation.] In other words, any duty the board may have to

1 minimize employer contributions ‘may not take precedence over its duty to the beneficiaries
2 of the system.’ [Citation.] Thus, no competing constitutional provision could require the
3 board to act in a manner detrimental to its beneficiaries. [Citation]” (*O’Neal II, supra*, 8
4 Cal.App.5th at p. 1204, citing *City of Sacramento v. Public Employees Retirement System* (1991)
5 229 Cal.App.3d 1470, 1494 (*City of Sacramento*).)

6 The intervenor County is simply a *third party* who benefitted from StanCERA’s breaches
7 of trust. The County is participating in the lawsuit not because the plaintiffs have alleged any
8 cause of action against it (e.g., aiding and abetting a breach of fiduciary duty), but because it
9 desires and intends to resist the disgorgement of ill-gotten gains.

10 **D. By Law, a Majority of the Members of StanCERA’s Governing Board**
11 **of Trustees Are County Officials or Appointees of the County Board**
of Supervisors.

12 Pursuant to Government Code section 31520.1, StanCERA is governed by a nine-
13 member board. Four of those members are appointed by the County board of supervisors and one
14 is the County Treasurer. (*Ibid.*) The current Chairman of the County’s board of supervisors, Jim
15 DeMartini (<http://www.co.stanislaus.ca.us/board>), serves on StanCERA’s retirement board
16 currently and was a member of StanCERA’s board at prior material times. (See
17 <http://www.stancera.org/board>.)

18 **E. While Serving as StanCERA Trustees, Board Members Must**
19 **Subordinate Their Loyalty to the County to the Interests of**
StanCERA’s Beneficiaries.

20 It is certainly natural to understand that the Chairman of the board of supervisors and four
21 trustees appointed by that governing body—who comprise a majority of StanCERA’s retirement
22 board—would be inclined to offer financial aid to the County in times of fiscal need. However,
23 in their capacity as trustees of a public pension retirement board, the nine members of StanCERA
24 wear only *one* hat; they owe only *one*, paramount, fiduciary duty of loyalty, and that is to the
25 beneficiaries of StanCERA. Mr. DeMartini and the four board members appointed by the County
26 board of Supervisors are not members appointed to represent or to promote the County’s
27 interests.

28 ///

1 **F. The Plaintiffs Must Prove the Three Elements of Their Cause of Action**
2 **for Breach of Fiduciary Duty—(1) the Existence of a Fiduciary Duty,**
3 **(2) Breach of the Fiduciary Duty, and (3) Harm to Their Trust Fund**
4 **Proximately Caused by the Breach.**

5 The three elements of a cause of action for breach of fiduciary duty are well established.
6 The plaintiffs must prove: (1) the existence of a fiduciary relationship, (2) breach of a fiduciary
7 duty, and (3) damage, i.e., harm to the plaintiffs’ trust fund, proximately caused by the breach.
8 (*Oasis West Realty, LLC v. Goldman* (2011) 51 Cal.4th 811, 820; *Davis v. Fresno Unified School*
9 *District* (2015) 237 Cal.App.4th 261, 293; *Meister v. Mensinger* (2014) 230 Cal.App.4th 381,
10 395; California Civil Jury Instructions, Nos. 4100-4102; *O’Neal II, supra*, 8 Cal.App.5th at p.
11 1215.)

12 The first element—the existence of a fiduciary relationship between StanCERA and the
13 member beneficiaries of the system, including the plaintiffs—is constitutionally based (§ 17,
14 subd. (a)) and undisputed.

15 The plaintiffs anticipate little dispute or not that StanCERA’s pension trust fund was
16 harmed by the five disputed actions taken by its board. StanCERA’s former actuary, Robert
17 McCrary has opined and will testify that the fund has been diminished by over \$100 million as a
18 result of those actions. (Exhs. 60, 69.)

19 The highly disputed element of the plaintiffs’ causes of action is whether StanCERA’s
20 five challenged actions breached the fiduciary duties of loyalty or prudence. That is the critical
21 issue for the court to determine in the liability phase of trial.

22 As to the duty of loyalty, the Court of Appeal explained in *O’Neal II*: “this common law
23 duty could render otherwise proper conduct a breach of fiduciary duty upon a showing the
24 conduct was taken ‘either [1] for the purpose of benefiting a third person (whether or not a party
25 to the transaction) rather than the trust estate or [2] for the purpose of advancing an objective
26 other than the purposes of the trust.’” (Rest.3d Trusts, § 78, com. f, p. 109.) As the court in *City of*
27 *Sacramento* succinctly noted, in the face of facts showing an improper influence ‘a “fiduciary
28 cannot contend ‘that although he had conflicting interests, he served his masters equally well or
29 that his primary loyalty was not weakened by the pull of his secondary one.’”’ (*City of*

1 *Sacramento, supra*, 229 Cal.App.3d at p. 1494)” (*O’Neal II, supra*, 8 Cal.App.5th at p.
2 1218.)

3 StanCERA’s oft-repeated statement that its decisions are entitled to deference, or that it
4 has discretion to act as it did, have been soundly rejected by the Court of Appeal and are law of
5 the case. In *O’Neal II* the court held: “As a preliminary matter, StanCERA argues the breaches
6 alleged in this case arose from discretionary decisions taken by the board and, thus, are entitled to
7 deference such that the board must be upheld if reasonable minds could disagree as to the
8 wisdom of the board’s actions. *We do not agree.*” (*O’Neal II, supra*, 8 Cal.App.5th at p. 1215,
9 italics added.)

10 The court further explained: “While it is true that the board acts under a grant of plenary
11 authority to administer the retirement system, this grant of discretion is not absolute. As
12 StanCERA admits, we explained in *O’Neal I* ‘the allegation in the amended complaint that
13 respondent breached its fiduciary duty is, in the circumstances of this case, the legal equivalent of
14 an allegation that [StanCERA’s] actions were a breach of discretion, since [StanCERA’s] board
15 *does not have lawful discretion to act in contravention of its constitutional duties.*’ This
16 conclusion was consistent with the law of trusts and the case law. (See Prob. Code, §§ 16081,
17 subd. (a) [‘[I]f a trust instrument confers “absolute,” “sole,” or “uncontrolled” discretion on a
18 trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith
19 or in disregard of the purposes of the trust.’]; 16202 [‘The grant of a power to a trustee, whether
20 by the trust instrument, by statute, or by the court, does not in itself require or permit the exercise
21 of the power. The exercise of a power by a trustee is subject to the trustee’s fiduciary duties.’];
22 *City of Sacramento, supra*, 229 Cal.App.3d at p. 1494, . . . [“The trustee is under a duty to the
23 beneficiary to administer the trust solely in the interest of the beneficiary.”].) It confirms that a
24 breach of a trustee’s fiduciary duty, if proven, demonstrates a breach of discretion, as a trustee’s
25 discretion is necessarily constrained by any fiduciary obligations. (See Rest.3d Trusts, §§ 70,
26 86.)” (*O’Neal II, supra*, 8 Cal.App.5th at pp. 1215-1216.)

27 Finally, the Court of Appeal held: “to be entitled to . . . judgment, StanCERA and County
28 must demonstrate one or more elements of a breach of fiduciary duty claim “cannot be

1 established, or that there is a complete defense to that cause of action.” (*O’Neal II, supra*, 8
2 Cal.App.5th at p. 1216.)

3 “Under the law of the case doctrine, when an appellate court “states in its opinion a
4 principle or rule of law necessary to the decision, that principle or rule becomes the law of the
5 case and must be adhered to throughout [the case’s] subsequent progress, both in the lower court
6 and upon subsequent appeal. . . .” [Citation.] Absent an applicable exception, the doctrine
7 ‘requir[es] both trial and appellate courts to follow the rules laid down upon a former appeal
8 whether such rules are right or wrong.’ [Citation.]” (*People v. Barragan* (2004) 32 Cal.4th 236,
9 246.)

10
11 **G. Under Evidence Code Section 115, “the Burden of Proof Requires
Proof by a Preponderance of the Evidence.”**

12 Evidence Code section 115 provides:

13 “*‘Burden of proof’ means the obligation of a party to establish by evidence a*
14 *requisite degree of belief concerning a fact in the mind of the trier of fact or the*
15 *court. The burden of proof may require a party to raise a reasonable doubt*
16 *concerning the existence or nonexistence of a fact or that he establish the*
17 *existence or nonexistence of a fact by a preponderance of the evidence, by clear*
18 *and convincing proof, or by proof beyond a reasonable doubt.*

19 *Except as otherwise provided by law, the burden of proof requires proof by a*
20 *preponderance of the evidence.*

21 (Italics added.)

22 Proof of a breach of fiduciary duty therefore requires proof by a preponderance of the
23 evidence, which means only that such a breach is “more likely to be true than not true” (CACI
24 No. 200)

25 **III. STATEMENT OF MATERIAL FACTS**

26 There should be no dispute that the trustees of StanCERA were required to “discharge
27 their duties with respect to the system with the care, skill, prudence, and diligence *under the*
28 *circumstances then prevailing* that a prudent person acting in a like capacity and familiar with
these matters would use in the conduct of an enterprise of a like character and with like aims.”
(§ 17, subd. (c).) Therefore, the financial condition of StanCERA in fiscal years 2009-2011—the
“circumstances then prevailing”—are very relevant to whether the trustees acted prudently in

1 drastically reducing the County's employer contributions. The evidence will show that the trust
2 fund was severely underfunded during that time period.

3
4 **A. In 2009 StanCERA Was Severely Underfunded; Its Funded Ratio
Had Fallen to 59.0 Percent.**

5 Before StanCERA took the five underfunding actions challenged in this case, it was
6 aware that the funded ratio of the pension fund had plummeted as a result of market losses and
7 the negligence of its prior actuary.

8 The funded ratio (liabilities divided by assets) had fallen from 96.6 percent on June 30,
9 2006, to 73.7 percent on June 30, 2008. (Exh. 41, p. 3; Exh. 43, p. 1.)

10 By June 30, 2009, the funded ratio had fallen to 59.0 percent. (Exh. 43, p.1.)

11
12 **1. The value of trust fund assets had declined by \$500 million,
approximately 30 percent.**

13 A memorandum dated March 6, 2009, to the board from Deputy County Counsel Deidre
14 McGrath and Retirement Administrator Tom Watson confirmed "[a]s your Board is well aware,
15 the StanCERA fund has lost approximately \$500 million dollars over the past year or so or about
16 30% of the portfolio." (Exh. 8.)

17
18 **2. Before StanCERA adopted its 2009 actuarial valuation, it
leaned that its prior actuary had made errors that understated
its actuarial liabilities by approximately \$38 million.**

19 StanCERA had also recognized that its prior actuary, Buck Consultants, had made
20 calculation errors which understated the County's required contributions⁵ for the two previous
21 years by approximately \$38 million. (Exh. 41, pp. 4, 9 ["[i]nsufficient employer contributions
22 have been collected in prior years".])

23 In short, the "circumstances then prevailing" (§ 17, subd. (c)) were that the assets of the
24

25 ⁵ Payment of the County's annual employer contribution is mandatory. (See, e.g.,
26 Gov. Code, §§ 31581 [board of supervisors "shall" appropriate funds], 31582 [requiring transfer
27 of funds], 31584 ["the board of supervisors shall make the appropriations"].) Under Government
28 Code section 31584, if the County's board of supervisors ever fails to make the necessary
appropriation, the County's auditor is required to make the contribution from the County
treasury. (See *O'Neal I, supra*, 2012 WL 1114677, *2.)

1 system were dangerously insufficient to pay the members' promised pensions. StanCERA badly
2 needed additional funds.

3
4 **B. From 2009-2011 the County Repeatedly Asked StanCERA To Lower the County's Annual Employer Contributions.**

5 Despite StanCERA's dramatically reduced funded ratio, the County repeatedly requested
6 contribution funding relief to help the County balance its annual budgets.

7 On April 3, 2009, the County's Chief Executive Officer wrote to StanCERA's Retirement
8 Administrator: "The County has significant concern over the [projected] employer contribution
9 rates recommended in the draft actuarial report [for fiscal year 2009-2010]" (Exh. 10.) The
10 County suggested that StanCERA take action to lower the County's employer contribution,
11 including "postponing" paying certain benefits, transferring reserves for payment of certain
12 benefits to count towards employer contributions, and lengthening the amortization period for the
13 growing unfunded liability from 20 to 30 years. (Exh. 10.)

14 The County made similar requests in 2010 and 2011. (Exh. 25 [observing that
15 StanCERA's 2008 actions substantially reduced required employer contributions and requesting
16 further contribution relief]; Exh. 29 [noting "StanCERA's willingness to mitigate employer paid
17 retirement costs" and "requesting the Retirement Board mitigate the County's retirement costs
18 for Budget Year 2011-2012 by the \$12.6 million that remains in the non-vested [health] benefit
19 reserve"].)

20 In short, the County wanted StanCERA to help balance the County's municipal budgets.
21 The County repeatedly engaged in the "political meddling" from which the People had sought to
22 insulate retirement boards (Act, § 2(f) ["to protect pension systems , retirement board trustees
23 must be free from political meddling and intimidation."].)

24 **C. In Order To Lower the County's Employer Contributions, StanCERA Used \$45.7 Million in Trust Fund Assets in Lieu of Actuarially
25 Required County Employer Contributions.**

26 As the health of the pension trust fund dramatically plunged, StanCERA imprudently, and
27 by the artifice of various actuarial schemes, manipulated the pension trust fund it administers in
28 order to *reduce* County employer contributions by tens of millions of dollars, rather than to

1 assure the competency of the assets of the plan (§ 17, subd. (e) [requiring that StanCERA’s
2 actuarial function be exercised “consistent with [its] exclusive fiduciary responsibilities” and “in
3 order to assure the competency of the assets of the public pension or retirement system”]).

4 StanCERA’s first maneuver was to use assets already in the pension fund to offset the
5 County’s annual required contributions.

6 **1. In 2009 StanCERA used \$10 million of trust fund assets to**
7 **offset the County’s employer contribution for fiscal year**
July 1, 2009, to June 30, 2010.

8 On April 28, 2009, StanCERA used \$10 million of trust fund assets to offset the County’s
9 employer contribution for fiscal year July 1, 2009, to June 30, 2010. (Exh. 21 [“The Board of
10 Retirement also approved a transfer of a \$10 million contribution from non valuation reserves as
11 an employer contribution for fiscal year 2009/10”]; Exh. 47, p. 71 [employers’ “annual required
12 contribution” was “comprised of a \$21,814,194 payment by the employers, plus an additional
13 \$10,000,000 in assets transferred from the non-valuation to valuation reserves”]; Exh. 27 [“The
14 Retirement Board acted on April 28, 2009 to transfer \$10 million of this reserve as an employer
15 contribution to offset all employers’ retirement contributions for FY 2009-2010”].)

16 **2. In 2010 StanCERA used \$21.4 million of trust fund assets to**
17 **offset the County’s employer contribution for fiscal year**
July 1, 2010, to June 30, 2011.

18 On April 27, 2010, StanCERA used \$21.4 million of trust fund assets to offset the
19 County’s employer contribution for fiscal year July 1, 2010, to June 30, 2011. (Exh. 42 [“on
20 April 27, 2010 . . . the Board of Retirement also approved a transfers of \$20 million and \$1.4
21 million from non valuation reserves to offset employer contributions for fiscal year 2010/11”];
22 Exh. 47, p. 71 [employers’ “annual required contribution” was comprised of a \$26,256,729
23 payment by the employers, plus an additional \$21,400,000 in assets transferred from the non-
24 valuation to valuation reserves”].)

25 **3. In 2011 StanCERA used \$14.3 million of trust fund assets to**
26 **offset the County’s employer contribution for fiscal year**
July 1, 2011, to June 30, 2012.

27 On April 13, 2011, StanCERA used \$14.3 million of trust fund assets to offset the
28 County’s employer contribution for fiscal year July 1, 2011, to June 30, 2012. (Exh. 44 [“on

1 April 13, 2011 . . . [t]he Board of Retirement approved a transfer of \$14.3 million from non
2 valuation reserves to offset employer contributions for fiscal year 2011/12”]; Exh. 47, p. 71
3 [employers’ “annual required contribution” was comprised of a \$27,314,032 payment by the
4 employers, plus an additional \$14,300,000 in assets transferred from the non-valuation to
5 valuation reserves”].)

6 These evasions of the County’s pension debts to StanCERA (annual required
7 contribution) allowed the County to spend \$45.7 million for other purposes.

8 **D. In Order To Further Lower the County’s Employer Contributions,**
9 **StanCERA Adopted a Schedule of *Negative Amortization* of Its**
10 **Unfunded Liability.**

11 StanCERA’s second maneuver was to adopt a schedule of negative amortization of the
12 retirement system’s unfunded liability. Because such liability is the responsibility of the public
13 *employer*, not employees, and must be amortized over a period no longer than 30 years (Gov.
14 Code, § 31453.5), a schedule including front-loaded, *negative* amortization reduces the County’s
15 annual employer contributions.

16 On or about April 28, 2009, even though the pension trust fund was underfunded in
17 excess of \$500 million dollars, StanCERA adopted a negative amortization schedule in which,
18 according to StanCERA’s actuary: “the amortization payment [required from the County under
19 Government Code section 31453.5] in [each] year will be less than the interest on the unfunded
20 amount—no payment towards ‘principal’ [debt] is made.” (Exh. 41, p. 10.) This action, which
21 minimizes employer contributions, is called “negative amortization.” (Exh. 17, p. 2
22 [“amortization with 18+ year period results in contribution that does not initially cover the
23 interest in the unfunded liability (so-called ‘negative amortization’)”].) This also “assisted the
24 County greatly in balancing its 2009-2010 Fiscal Year budget.” (Exh. 25.) However, StanCERA
25 was warned by its actuary that “[b]ecause of this change, the projected rate of recovery in *the*
26 *funding level will be significantly curtailed* [and] the funded ratio is expected to be 10%
27 lower at the end of ten years than it would be under the old amortization policy.” (Exh. 41, p. 10,
28 italics added.)

///

1 **E. In Order To Further Lower the County’s Employer Contributions,**
2 **StanCERA Transferred \$50 Million from *Non-Valuation* Reserves**
3 **to *Valuation* Reserves.**

4 StanCERA’s third maneuver to lower the County’s employer contributions was to
5 transfer \$50 million from “non-valuation” reserves to “valuation” reserves. On or about April 28,
6 2009, StanCERA used \$50 million of trust fund assets to reduce the County’s employer
7 contribution for fiscal year July 1, 2009, to June 30, 2010. (Exh. 21 [“Transferring \$50 million
8 from valuation to non valuation reserves”]; Exh. 41, p. 4 [“The Board made several policy
9 decisions (moving \$50 from non-valuation to valuation reserves . . .) that lowered the employer
10 contribution rate”]; Exh. 17 [“For each dollar transferred from the non-valuation reserves to the
11 valuation reserves . . . the current [employer] contribution (FY2009-2010) will drop by about
12 \$.10”]; Exh. 25 [“transfer of \$50 million . . . assisted the County greatly in balancing its 2009-
13 2010 Fiscal Year budget”].)

14 “Non-valuation reserves” can be, and were, established by StanCERA from excess
15 earnings in given years. (Gov. Code, § 31592.2.) While retired members have no “vested” right
16 to receive statutorily authorized cost-of-living benefits, health benefits, and death benefits, non-
17 valuation reserves may be used, in the retirement board’s discretion, to provide such ancillary
18 “benefits” (§ 17, subd. (a)) to retirees. (*O’Neal II, supra*, 8 Cal.App.5th at pp. 1200-1201.)

19 Significantly, as the name implies, non-valuation reserves are not included by actuaries in
20 calculating the annual contributions that public employers are required to make to fund “vested”
21 pension benefits. The evidence will show that for every dollar transferred from non-valuation
22 reserves to valuation reserves, the County save approximately \$.10. Therefore, the transfer of \$50
23 million in 2009 saved the County approximately \$5 million in annual contributions.

24 **F. There Is No Evidence That StanCERA Took the Disputed Actions**
25 **for Any Purpose Other Than To Help the County.**

26 To the extent that public information is available related to the disputed actions taken by
27 StanCERA, including transcripts of public meetings, there is no evidence that the retirement
28 board took those actions for any purpose other than to help the County balance its municipal
 budgets in fiscal years 2009-2011.

1 **G. Because the Defendants Asserted the Deliberative Process Privilege**
2 **in Discovery, There Is No Admissible Evidence, and No Inference**
3 **Favorable to the Defendants May Be Drawn, Regarding the**
4 **Reasons Why StanCERA Took the Disputed Actions.**

5 For reasons explained in “Plaintiffs’ Motion in Limine No. 1: To (A) Exclude All
6 Evidence Within the Scope of the Privileges That Were Asserted to Prevent Discovery and (B) to
7 Preclude Any Inference Regarding Stancera’s Reasons for the Disputed Actions”:

- 8 • the defendants successfully asserted the deliberative process and
9 attorney-client privileges to prevent discovery;
- 10 • evidence as to which a party asserts a privilege in discovery is
11 inadmissible at trial; and
- 12 • the court cannot draw any inference from the limited circumstantial
13 evidence as to which a privilege was waived that StanCERA had a
14 “good” reason to take the disputed actions.

15 Because the defendants asserted the deliberative process privilege in discovery, there is no
16 admissible evidence, and no inference favorable to the defendants may be drawn, regarding the
17 *reasons* why StanCERA took the disputed actions.

18 **IV. STANCERA BREACHED ITS FIDUCIARY DUTIES OF LOYALTY AND**
19 **PRUDENCE BY USING \$45.7 MILLION OF TRUST FUND ASSETS TO**
20 **OFFSET ACTUARIALLY REQUIRED EMPLOYER CONTRIBUTIONS.**

21 **A. StanCERA’s Duty of Loyalty to Its Participants and Their Beneficiaries Is**
22 **the Most Stringent Duty Imposed By the Law of Trusts, and “Shall Take**
23 **Precedence Over Any Other Duty.”**

24 As the Court of Appeal explained in *O’Neal II*, “the most stringent duty imposed by the
25 law of trusts [is] the duty of loyalty. According to the Restatement Third of Trusts section 78,
26 subdivision 1, ‘[e]xcept as otherwise provided in the terms of the trust, a trustee has a duty to
27 administer the trust solely in the interest of the beneficiaries.’ (Accord, Prob. Code, § 16002,
28 subd. (a) [‘The trustee has a duty to administer the trust solely in the interest of the
 beneficiaries.’].) Although this duty is frequently invoked as a protection against creating
 conflicts between a trustee’s fiduciary duties and personal interests, it is also understood to

1 protect against improper influence generally. Thus, actions by a trustee may be considered
2 improper if they are taken ‘either for the purpose of *benefiting a third person* (whether or not a
3 party to the transaction) rather than the trust estate or for the purpose of advancing an objective
4 other than the purposes of the trust.’ (Rest.3d Trusts, § 78, com. f, p. 109; accord, Prob. Code,
5 § 16004, subd. (a) [‘The trustee has a duty not to use or deal with trust property for the
6 trustee’s own profit or for any other purpose unconnected with the trust. . . .’].) This duty of
7 loyalty strongly parallels provisions of section 17 added by Proposition 21 and amended by
8 Proposition 162. (§ 17, subd. (b) [“The members of the retirement board of a public pension or
9 retirement system shall discharge their duties with respect to the system solely in the interest of,
10 and for the exclusive purposes of providing benefits to, participants and their beneficiaries,
11 minimizing employer contributions thereto, and defraying reasonable expenses of administering
12 the system. *A retirement board’s duty to its participants and their beneficiaries shall take*
13 *precedence over any other duty.*’].)” (*O’Neal II, supra*, 8 Cal.App.5th at pp. 1209-1210, italics
14 added.)

15
16 **B. SDCERA Breached Its Duty of Loyalty by Using Trust Assets To
Offset the County’s Actuarially Required Employer Contributions.**

17 At trial, the plaintiffs will demonstrate that StanCERA breached its duty of loyalty by
18 using \$45.7 million of trust fund assets to offset and skip the collection of actuarially required
19 employer contributions. This proof will include the testimony of the plaintiffs’ expert William
20 Sheffler.

21 Mr. Sheffler is a licensed, practicing actuary who has provided actuarial services for
22 pension plans for more than 40 years. He has provided actuarial and consulting services related to
23 public and private pension plans since 1975. Mr. Sheffler obtained a Bachelor of Arts degree in
24 1969 from Claremont Men’s College in mathematics and economics. Mr. Sheffler also obtained
25 a Master of Arts degree in mathematics in 1971 from the University of Arizona.

26 Mr. Sheffler has five actuarial certifications, many of which require demonstration of
27 proficiency and continuing education. Among his professional affiliations, which require an
28 examination and experience, he is an enrolled actuary, a Fellow in the Conference of Consulting

1 Actuaries, an Associate in the Society of Actuaries, a Member of the American Academy of
2 Actuaries, and a Member of the of American Society of Pension Professionals and Actuaries.

3 In 2003, based on his background and experience, Mr. Sheffler was appointed by the
4 Mayor of San Diego to the Pension Reform Commission. That commission was asked to
5 examine the San Diego City Employees' Retirement System ("SDCERS"), to explain how
6 SDCERS had become underfunded, and to make recommendations regarding improving the
7 funded status of SDCERS and other actuarial issues.

8 In 2005, Mr. Sheffler was appointed by the Mayor of San Diego to serve as a member of
9 the Board of Trustees of SDCERS. He served as trustee of SDCERS for four years and received
10 extensive training and education regarding application of the fiduciary duties which relate to his
11 testimony. He is the only expert in this case who has ever served as a public pension trustee. Mr.
12 Sheffler was required to apply his fiduciary duties (including Cal. Const. Art. XVI, § 17) on
13 scores, if not hundreds, of occasions while he served as a member of the Board of Trustees of
14 SDCERS. These duties, as the Court of Appeal has made clear, include the fiduciary duties of
15 loyalty and prudence. (*O'Neal II, supra*, 8 Cal.App.5th at pp. 1202, 1204, 1209-1210, 1218-
16 1222.)

17 Mr. Sheffler will testify that:

- 18 1. StanCERA's use of \$10 million of trust fund assets (formerly used
19 to pay benefits to members) to offset the County's employer
20 contribution for fiscal year July 1, 2009, to June 30, 2010, placed
21 the interests of the employers over the interest of trust
22 beneficiaries, i.e., breached its duty of loyalty and was imprudent.
23 Additionally, StanCERA's action was actuarially unsound.
- 24 2. StanCERA's use of \$21.4 million of trust fund assets (formerly
25 used to pay benefits to members) to offset the County's employer
26 contribution for the fiscal year July 1, 2010, to June 30, 2011,
27 placed the interests of the employers over the interest of trust
28 beneficiaries, i.e., breached its duty of loyalty and was imprudent.

1 Additionally, StanCERA's action was actuarially unsound.

2 3. StanCERA's use of \$14.3 million of trust fund assets (formerly used to
3 pay benefits to members) to offset the County's employer contribution for
4 the fiscal year July 1, 2011, to June 30, 2012, placed the interests of the
5 employers over the interest of trust beneficiaries, i.e., breached its duty of
6 loyalty and was imprudent. Additionally, StanCERA's action was
7 actuarially unsound.

8 In short, StanCERA declined to collect the County's debts to the retirement system.

9 Mr. Sheffler will offer ample reasoned bases for his opinions: the five StanCERA actions
10 challenged by the plaintiffs in this case are *actuarially unsound* practices that permit the trust
11 fund to become underfunded (which it is and has been ever since StanCERA's conduct), and are
12 very difficult to correct. Mr. Sheffler will explain how difficult that underfunding has been to
13 correct in the City of San Diego and with SDCERS

14 Mr. Sheffler will also explain, as he did in his depositions, that defined-benefit pension
15 plans are primarily funded by investment earnings, and timely contributions are critical to
16 maintaining the integrity of such plans. By substituting pension fund assets for required
17 employer contributions, the pension fund has lost not only those contributions, but also the
18 investment earnings which would have been generated by those contributions. (*Board of*
19 *Administration v. Wilson* (1997) 51 Cal.App.4th 1109, 1142-1144.) This results in long-term
20 damage to the pension fund, particularly in light of StanCERA's use of a negative amortization
21 schedule that fails to reduce the system's unfunded liability. In the words of StanCERA's
22 actuary, Mr. McCrory: "no payment toward 'principal' is made" and "[b]ecause of this change,
23 the projected rate of recovery in the funding level will be significantly curtailed . . . [and] the
24 funded ratio is expected to be 10% lower at the end of ten years than it would be under
25 [StanCERA's former] amortization policy." (Exh. 41, p. 10.)

26 ///

27 ///

28 ///

1 **C. Forgoing Required, Annual Employer Contributions Violates**
2 **Actuarial Science and Renders a Defined-Benefit Pension**
3 **System Actuarially Unsound.**

4 1. *The beneficiaries of a defined-benefit, public pension system*
5 *have a right to a system that is actuarially sound.*

6 An extremely important case relevant to this trial is *Board of Administration v. Wilson,*
7 *supra*, 51 Cal.App.4th 1109. In that case, the court held that the members of a public pension
8 system, such as StanCERA, “have a contractual right to an actuarially sound retirement
9 system” and that the right to an actuarially sound retirement system is protected by the contracts
10 clauses of the state and federal constitutions. (*Id.* at pp. 1127–1137.)

11 2. *Actuaries assume that employer contributions will be made*
12 *when required, and that earnings will be generated at an*
13 *assumed rate on the contributed funds.*

14 As Mr. Sheffler will testify, and as the court in *Board of Administration v. Wilson, supra,*
15 51 Cal.App.4th at p. 1139 explained: “[public pension] plans [like StanCERA’s] are pre-funded.
16 Instead of allocating money at or near the time that benefits become due, a prefunded plan relies
17 upon an orderly schedule of contributions well in advance of benefit requirements The
18 willingness and ability of the sponsor of a defined benefit pension plan to maintain this ‘orderly
19 schedule’ is the major factor in the assurance of benefit security for retirees and in the
20 maintenance of intergenerational taxpayer equity. . . . In the determination of the value of the
21 employer contribution, it is necessary to make an assumption as to when the contribution will be
22 made. This is because investment earnings are assumed to begin accruing when the contribution
23 is made. When contributions are delayed beyond the date assumed, the plan falls out of actuarial
24 balance and actuarial soundness is endangered.”

25 Further as Mr. Sheffler will explain: “[t]he funding method used by [StanCERA] is a[n] .
26 . . entry-age-normal cost method. Under this method, the employer cost is calculated in two
27 distinct pieces: the plan normal cost and the unfunded liability cost. Each of these two pieces is
28 determined as a level percentage of payroll expected to continue as such until a future point in
29 time. The employer contribution rate is the sum of the two and is likewise expressed as a
30 percentage of payroll. . . . A normal cost is determined for each member as the level percentage

1 of pay which is expected to accumulate, together with the member's contributions, to an amount
2 sufficient to completely fund that member's benefits at his or her retirement date had funding
3 been initiated at his or her entry into the plan. The plan normal cost is the weighted (by salary)
4 average of all the individual normal costs The accumulation of plan normal costs is called
5 the plan's accrued actuarial liability. When the accrued actuarial liability exceeds the plan assets,
6 an unfunded accrued actuarial liability exists. . . . *Underpinning both the normal cost calculation*
7 *and the amortization of the unfunded accrued actuarial liability is an explicit assumption*
8 *concerning the timing of contributions. The importance of timing stems from the fact that a large*
9 *portion of a member's benefit is funded by the investment earnings which are generated by plan*
10 *contributions. When monies are contributed later than expected, reduced earnings result—thus*
11 *creating a shortfall. This impairs benefit security and causes a portion of the total current*
12 *employment cost of plan members to be shifted into the future. This shift of costs can accurately*
13 *be characterized as a loan to cover the current employee costs—a loan that must be repaid*
14 *by future generations of taxpayers.” (Board of Administration v. Wilson, supra, 51 Cal.App.4th*
15 *at pp. 1139-1140, italics added.)*

16 Thus, *timely* employee and employer contributions are the lifeblood of maintaining
17 StanCERA's actuarial soundness. Here, all employee contributions were *always made* on a
18 timely basis. However, StanCERA allowed the County to skip three successive years of
19 actuarially required contributions. (Exh. 47, p. 71.)

20
21 **D. It Is Imprudent To Lower Employer Contributions Whenever a
Public Pension System Is Severely Underfunded.**

22 Finally, as explained above in Section IV(B), based on his actual experience as a trustee
23 from his years correcting similar mistakes by a public pension plan, Mr. Sheffler will also
24 explain why StanCERA's actions were imprudent.

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26 ///

27 ///

28 ///

1 **V. STANCERA BREACHED ITS FIDUCIARY DUTIES OF LOYALTY**
2 **AND PRUDENCE BY ADOPTING AN ACTUARIALLY UNSOUND**
3 **SCHEDULE OF NEGATIVE AMORTIZATION OF UNFUNDED**
4 **LIABILITY.**

5 **A. The *Negative Amortization of Unfunded Liability Benefitted Only***
6 **the County, by Lowering Annual Employer Contributions.**

7 Several trial exhibits will demonstrate that StanCERA adopted policies, including
8 “negative amortization” of the burgeoning unfunded liability of the pension fund, simply to
9 reduce the amount of money the County had to contribute for its annual employer contributions.
10 With negative amortization, in the words of StanCERA’s actuary, “no payment toward
11 ‘principal’ is made” and “[b]ecause of this change [in adopting a negative amortization
12 schedule], the projected rate of recovery in the funding level will be significantly curtailed
13 . . . [and] the funded ratio is expected to be 10% lower at the end of ten years than it would be
14 under [StanCERA’s former] amortization policy.” (Exh. 41, p. 10.)

15 StanCERA’s actuary also explained that StanCERA acted only to help the County, not
16 any of the other four employers for which StanCERA administers pension funds: “[In addition
17 to] [t]he Board extend[ing] the current amortization period from 20 to 30 years, [StanCERA also]
18 modified the amortization method to be a level percentage of payroll approach. No change was
19 made to the amortization policy of the City of Ceres or the Other Districts. Under the prior (level
20 dollar) method, the amortization payment was calculated as a constant annual amount. Under the
21 revised method, the amortization payment is expected to increase each year, at the same rate as
22 the expected payroll growth. These two changes in amortization policy – lengthening the period
23 and going to level percentage of pay—push a greater portion of the amortization payments into
24 future years, thus reducing the current payment amount [for the County]—by 4.73% of payroll.”
25 (Exh. 41, p. 10.) Because the County’s payroll was slightly more than \$200 million (Exh. 41, p.
26 64), this maneuver saved the County approximately \$9.46 million.

27 Finally, in 2009 StanCERA adopted a policy of resetting the amortization schedule to 30
28 years for at least three years. (Exh. 41, p. 46.)

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1 **B. The Negative Amortization of Unfunded Liability Harmed**
2 **Beneficiaries, by Lowering the Funded Ratio of the Trust Fund.**

3 As explained in the previous section, StanCERA’s own actuary warned StanCERA that
4 its amortization maneuver would keep StanCERA’s “significantly curtail[]” the funding of
5 earned, vested benefits: “[T]he funded ratio is expected to be 10% lower at the end of ten years
6 than it would be under [StanCERA’s former] amortization policy.” (Exh. 41, p. 10.)

7 This prediction proved to be correct. Although the stock market—in which StanCERA is
8 heavily invested—has increased 400% since 2008, StanCERA’s funded ratio has barely
9 improved. “When monies are contributed later than expected, reduced earnings result—thus
10 creating a shortfall. This impairs benefit security and causes a portion of the total current
11 employment cost of plan members to be shifted into the future. This shift of costs can accurately
12 be characterized as a loan to cover the current employee costs—a loan that must be repaid by
13 future generations of taxpayers.” (*Board of Administration v. Wilson, supra*, 51 Cal.App.4th at p.
14 1140.)

15 **C. Adoption of Amortization Policies Designed To Reduce the County’s**
16 **Contribution at the Expense of Significantly Curtailing Funding of**
17 **Vested Benefits Violates StanCERA’s Stringent Duty of Loyalty.**

18 Mr. Sheffler will also explain why StanCERA’s conduct regarding the amortization of
19 StanCERA’s burgeoning underfunding breached StanCERA’s duty of loyalty. He will testify
20 that StanCERA’s adoption of a negative amortization schedule on April 28, 2009, and its
21 continued use of negative amortization thereafter placed the interests of the employers over the
22 interest of trust beneficiaries, i.e., breached its duty of loyalty and was imprudent. Additionally,
23 StanCERA’s action was actuarially unsound.

24 Mr. Sheffler will be the only witness to testify on this issue. As the Court of Appeal
25 previously explained in this case: “[B]y both extending the period for amortizing the debt and
26 switching to a level percent of pay schedule, the evidence could be viewed to show the board
27 ensured a substantial period of negative amortization would occur and that, absent change, the
28 actuarial soundness of the system would decrease over a 10-year period. At the same time, the
board adopted a policy which would reset the 30-year amortization period each year for three

1 years, which could be viewed as ensuring at the time that the unfunded liabilities of the fund
2 would increase each of those years and, potentially, in perpetuity. This *perpetual underfunding*
3 could support an inference that the decisions made by the board were not taken in the exclusive
4 interest of its members.” (*O’Neal II, supra*, 8 Cal.App.5th at p. 1221, italics added.)

5
6 **D. StanCERA’s Policies to (1) Lower the Funded Ratio by Negative Amortization and (2) Increase the Threshold Funded Ratio Before Ancillary Benefits May Be Paid—Constitute a Breach of Its Fiduciary Duty of Loyalty.**

7
8 **1. A retirement board has a duty to manage the retirement system to facilitate the payment of “benefits,” not just “vested benefits,” to members.**

9
10 Section 17(a) provides, in part: “The retirement board shall also have sole and exclusive
11 responsibility to administer the system in a manner *that will assure prompt delivery of benefits*
12 *and related services to the participants and their beneficiaries.*” (Italics added.)

13 Section 17(a) makes no distinction between vested and non-vested (ancillary) benefits.
14 StanCERA should administer the system to deliver ancillary cost-of-living benefits, health
15 benefits, and death benefits to the extent such benefits are authorized by CERL.

16
17 **2. Under CERL, retirement boards may create non-valuation reserves from excess earnings and may use those reserves to pay statutorily authorized cost-of-living, health, and death benefits (“ancillary benefits”) to retired members.**

18
19 As the Court of Appeal explained in *O’Neal II*, “As noted, one source of funds for the
20 payment of retirement benefits is the income from investment of previous contributions to the
21 retirement fund. When the board of retirement determines the liabilities and assets of the fund, it
22 (guided by its actuary) makes certain assumptions about liabilities (including the age and final
23 compensation of employees when they retire) and assets (including the interest or rate of return
24 on existing assets as a source of funds to pay benefits). If the investment earnings during a
25 particular year exceed the amount credited by the board to contributions and reserves for that
26 year, these excess earnings ‘shall remain in the fund as a reserve against deficiencies in interest
27 earnings in other years, losses on investments, and other contingencies, except that, when such
28 surplus exceeds 1 percent of the total assets of the retirement system, the board may transfer all,

1 or any part, of such surplus in excess of 1 percent . . . for the sole purpose of payment of the cost
2 of the benefits described in this chapter.’ (§ 31592.2, subd. (a).) Among the ‘benefits described in
3 this chapter’ for which excess earnings may be used is the payment of ‘all, or a portion, of the
4 premiums, dues, or other charges for health benefits’ for retirees. (*Id.*, subd. (b).) Retirees have
5 no vested interest in the payment of these supplemental benefits, which are provided at the option
6 of [StanCERA]. (70 Ops.Cal.Atty.Gen. 1, 4 (1987).) Another of these nonvested benefits is a
7 potential annual increase in cost of living payments when the statutory amount is less than the
8 calculated increase in cost of living for the year. (§ 31874.3, subd. (a).)” (*O’Neal II, supra*, 8
9 Cal.App.5th at pp. 1200-1201.)

10 **3. *StanCERA’s policies operate jointly to prevent, not facilitate,***
11 ***the payment of ancillary benefits to retired members.***

12 In addition to acting to “significantly curtail[]” StanCERA’s funded status, StanCERA
13 also adopted policies making it impossible to grant any ancillary or supplemental benefits until
14 the funded ratio increased to 100 percent. (Exhs. 63-64.) The combination of StanCERA’s
15 policies to simultaneously reduce the funded ratio, and at the same time adopting a policy that
16 forbid provision of ancillary benefits until the funded ratio increased to at least 100 percent,
17 StanCERA breached its duty of loyalty. It managed the system to put the provision of such
18 benefits out of reach.

19 As explained by the Court of Appeal in *O’Neal II, supra*, 8 Cal.App.5th at pp. 1219-
20 1220:

21 County further contends appellants have no evidence of damages. We disagree. At
22 a minimum, appellants have demonstrated a reduction occurred to supplemental
23 benefit non-reserve funds which reduced the funding in those accounts. This
24 reduction was a result of an alleged breach of fiduciary duty by the board and calls
25 into question *whether such discretionary payments could ever be reinstated*,
26 regardless of their discretionary nature. If a breach of fiduciary duty is proven
27 there is little weight in the argument that these non-valuation accounts could have
28 been closed or that StanCERA could have voluntarily chosen to cease payments
from them, the reduction in value would be due to the breach, not any lawful act,
and therefore would constitute damages. (See *Uzyel v. Kadisha* (2010) 188
Cal.App.4th 866, 906, 116 Cal.Rptr.3d 244 [noting, in the context of a breach of
loyalty, which was allegedly consistent with the prudent investor rule, it “is no
defense that the trustee acted in good faith, that the terms of the transaction were
fair, or that the trust suffered no loss or the trustee received no profit”].) In other
words, while StanCERA has no fiduciary obligation to *pay* non-vested benefits, *it*
does have a duty to maintain those trust funds according to its fiduciary

1 *responsibilities. If the trust fund corpus is reduced due to a breach of those*
2 *duties, as opposed to a lawful reason, damages can be demonstrated through a*
3 *reduction of funds that would otherwise be present absent a breach.* There is thus
evidence in the record to support a damages claim resulting from an alleged
breach of the duty of loyalty.

4 (Footnotes 8 and 9 omitted, italics added.) In footnote 9, the Court explained: “For this reason,
5 we find County’s citations to *Chaidez v. Board of Administration etc.* (2014) 223 Cal.App.4th
6 1425, 169 Cal.Rptr.3d 100 and *City of Pleasanton v. Board of Administration* (2012) 211
7 Cal.App.4th 522, 149 Cal.Rptr.3d 729 distinguishable. Both cases dealt with an alleged
8 obligation to *pay* benefits higher than statutorily required, not with the duty to *properly manage*
9 *the underlying funds* which would support those payments.” (Italics added.)

10 **E. It Is Imprudent To Lower Employer Contributions Whenever a**
11 **Public Pension System Is Severely Underfunded.**

12 Finally, as explained above in Section V(C), above, based on his actual experience as a
13 trustee from his years correcting similar mistakes by a public pension plan, Mr. Sheffler will also
14 explain why StanCERA’s actions were imprudent.

15
16 **VI. STANCERA BREACHED ITS FIDUCIARY DUTIES OF LOYALTY**
17 **AND PRUDENCE BY ITS ACTUARIALLY UNSOUND TRANSFER OF**
18 **\$50 MILLION OF NON-VALUATION RESERVES TO VALUATION**
19 **RESERVES AND ADOPTING POLICIES EFFECTIVELY PREVENTING**
20 **THE PAYMENT OF ANCILLARY BENEFITS.**

21 Evidence at trial will demonstrate that StanCERA also depleted the non-valuation reserve
22 which had been created and built up by previous boards to pay ancillary benefits, notably a
23 payment of \$340 per month towards retiree health insurance premiums. (Exh. 21.) StanCERA’s
24 actuary reported to StanCERA that “[f]or each dollar transferred from the non-valuation reserves
to the valuation assets as of 6/30/2008, the [employer’s] current contribution (FY2009-2010) will
drop by \$.10” (Exh. 17, p. 1.)

25 Mr. Sheffler will testify that StanCERA’s maneuver was actuarially unsound, because it
26 simply decreased the money being contributed into a severely underfunded pension trust fund.
27 The reduction in employer contributions also reduced investment earnings for all future years.
28 He will testify that StanCERA’s use of \$50 million of trust fund assets (formerly used to pay

1 benefits to members) to reduce the County's employer contribution for the fiscal year beginning
2 July 1, 2009, placed the interests of the employers over the interest of trust beneficiaries, i.e.,
3 breached its duty of loyalty and was imprudent.

4 As set forth in Section V(D) above, the Court of Appeal has recognized that retired
5 members have a legitimate interest in the payment of ancillary benefits, even though they have no
6 "vested right" to receive those statutorily authorized benefits. Retired members were harmed by
7 StanCERA's *action*—in transferring \$50 million from non-valuation reserves to valuation
8 reserves—coupled with its *policies*—in (1) adopting a schedule of negative amortization of
9 unfunded liability and (2) suspending the payment of ancillary benefits until an intentionally
10 unattainable funded ratio is achieved. StanCERA created non-valuation reserves from excess
11 earnings. However, instead of using such reserves to provide ancillary benefits, it spent those
12 reserves by using \$45.7 million of them to offset and forgo large portions of the County's annual
13 required employer contributions.

14 StanCERA's claim that the transfer of \$50 million to valuation reserves helped all
15 members—by increasing the ratio of funds available to pay *vested* benefits—is pretextual and
16 false. StanCERA was simultaneously using trust assets to offset actuarially required employer
17 contributions, and adopting amortization schemes designed to save the County almost ten
18 million dollars per year. If StanCERA wanted to *improve* its funded ratio, it would never have
19 taken the latter two actions.

20 21 **VII. CONCLUSION**

22 **A. The Court Should Rule that StanCERA Breached Its Fiduciary** 23 **Duties to Members and That Its Breaches Caused Demonstrated** 24 **Harm to the Pension Trust Fund and Retired Members.**

25 For unknowable reasons, the trustees of StanCERA used their trust and actuarial powers
26 to help the County balance its annual municipal budgets, rather than to assure the competency of
27 the assets of the pension trust to pay for promised pension benefits. Even though "[a] retirement
28 board's duty to its participants and their beneficiaries [must] take precedence over any other
duty" (§ 17, subd. (b)), the trustees of StanCERA gave precedence to minimizing the County's

1 annual, employer contributions. Even though the clear purpose of The California Pension
2 Protection Act of 1992 was to *prevent* raids on pension trust funds, the retirement board of
3 StanCERA *implemented* such raids. And the board's trust management policies have essentially
4 put the provision of ancillary cost-of-living benefits, health benefits, and death benefits to retired
5 members out of the range of possibility.

6 The court should conclude that (1) StanCERA owed fiduciary duties of loyalty and
7 prudence to its members; (2) StanCERA breached those fiduciary duties; and (3) its breaches
8 caused demonstrated harm to the pension trust fund and retired members.

9
10 **B. The Court Should Set a Date To Try Issues Regarding the
Appropriate Equitable Remedies for StanCERA's Breaches.**

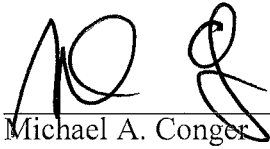
11 The pension trust fund should be restored to the position it would be in but for
12 StanCERA's breaches. The County—the aider, abettor, and beneficiary of StanCERA's
13 breaches—should be required to pay the \$45.7 million in actuarially required employer
14 contributions that StanCERA permitted it to avoid (i.e., by wrongfully using trust assets to offset
15 those contributions), together with lost interest. The \$50 million transferred from non-valuation
16 reserves to valuation reserves should be restored.

17 If the parties cannot reach agreement regarding the remedial measures required by trust
18 law, the court should set a date to try remaining issues regarding the appropriate equitable
19 remedies for StanCERA's breaches.

20 Dated: May 15, 2018

LAW OFFICE OF MICHAEL A. CONGER

21
22
23 By:



Michael A. Conger
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