



Mark A. Hovey
Chief Executive Officer

September 9, 2011

City Council Members
The City of San Diego
202 C Street, MS #10A
San Diego, CA 92101

RE: Ordinance O-2012-3 (SDCERS' Settlement Authority)

In a letter dated July 22, 2011, from SDCERS General Counsel Elaine Reagan to City Attorney Jan Goldsmith (copy enclosed), SDCERS raised several questions and provided preliminary conclusions regarding the legality of proposed Ordinance O-2012-3 ("the Ordinance"). The purpose of this letter is to provide additional comment on the Ordinance.

In summary:

- We conclude that the Ordinance is unconstitutional because it restricts a power granted exclusively to the SDCERS Board by the California Constitution and the City Charter.
- We conclude that the Ordinance is an unconstitutional impairment of contract under the federal and state constitutions because it is narrowly tailored to modify the terms of the Participation Agreement and Group Trust between the City and SDCERS rather than part of a broad public program which incidentally affects the Participation Agreement.
- We conclude that the Ordinance puts SDCERS' attorney-client privilege in jeopardy because SDCERS' request for settlement approval would be required to be presented to the City Council during open session.
- We conclude that the *Grimm* case cited by the City in support of the Ordinance provides no authority for the Council to enact this change.

Background and Legal Research supporting our conclusions:

1. Is the Ordinance unconstitutional because it violates Article XVI, section 17 of the California Constitution and San Diego City Charter section 144?

"Notwithstanding any other provisions of law or this constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of monies and administration of the system. . . . The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system." Cal. Const., art. XVI, §17

“The Board of Administration . . . shall have exclusive control of the administration and investment of such fund . . .” San Diego City Charter, section 144.

In Ms. Reagan’s July 22, 2011 letter, she raised questions relating to the constitutionality of the Ordinance and stated SDCERS’ belief that the Ordinance violated both the California Constitution and the City Charter. SDCERS’ belief was based on the plain language of the Constitution, the Charter and portions of the Probate Code.

When asked whether this was true at the first reading of the Ordinance, City Attorney Jan Goldsmith stated it was not.

Based on additional research conducted since that date, including cases interpreting the statutory authorities previously cited, SDCERS has now concluded that the Ordinance is unconstitutional because it restricts a power granted exclusively to the SDCERS Board by the California Constitution and the City Charter. The conclusion is based on the following:

The SDCERS Board of Administration (“Board”) has the “sole and exclusive fiduciary responsibility” over the assets of the System [Cal. Const., art. XVI, §17] and “exclusive control of the administration” of the System [Cal. Const., art. XVI, §17, San Diego City Charter §144]:

- The grant of exclusive authority in the California Constitution was intended to “protect such boards from ‘political meddling and intimidation,’” to “strictly limit the Legislature’s power over such funds,” and to “insulate the administration of retirement systems from *oversight and control* by legislative and executive authorities.” *City of San Diego v. SDCERS*, (2010) 186 Cal.App.4th 69 (emphasis added).
- The Board’s plenary authority is “limited to actuarial services and to the protection and delivery of the assets, benefits and services for which the Board has a fiduciary responsibility.” *Westly v. Board of Administration*, (2003) 105 Cal.App.4th 1095 (emphasis added).
- The Board has a fiduciary duty to “take and keep control of and to preserve the trust property.” Cal. Probate Code §16006. The Board has a duty to “take reasonable steps to defend actions that may result in a loss to the trust.” Cal. Probate Code §16011. The Board may not “delegate to others the performance of acts that the trustee can reasonably be required personally to perform.” Cal. Probate Code §16012.

The administration of the System, and the accompanying responsibility for defense and settlement of claims and litigation is a necessary discretionary service required of the SDCERS Board in the course of its administration. It is the Board *not the City* that has exclusive control of the funds and is responsible for managing the funds. It is the Board *not the City* that is granted the “sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system.” *Lexin v. Superior Court* (2010) 47 Cal. 4th 1050, 1093.

As provided in the California Constitution and the City Charter, responsibility for the assets of the System and administration of the System falls within the sole and exclusive jurisdiction of the Board. The Board's decision to defend or settle a case falls within its sole and exclusive power to both administer and protect the assets of the System. The proposed ordinance intrudes upon that sole and exclusive power by giving the City Council oversight and control over the Board's discretion vis-à-vis settlement of claims against the System. Statutes that impinge upon a function reserved exclusively to the Board are subject to a challenge of facial unconstitutionality. *Superior Court v. County of Mendocino* (1996) 13 Cal. 4th 45, 54.

2. Is the Ordinance unconstitutional because it unreasonably impairs an existing contract?

"The Plan agrees to abide by the terms of the Group Trust with respect to its participation in the Group Trust." City of San Diego's Participation and Administration Agreement with SDCERS, section 1.2, signed by Jay M. Goldstone, Chief Operating Officer on February 21, 2008 and approved by the City Council on September 25, 2007 in Resolution 303037.

"The Trustee has, with respect to any property at any time held by it as part of the Group Trust, power in its discretion: (n) Litigation. To settle, compromise or submit to arbitration any claims, debts or damages due or owing to or from the Group Trust; to commence or defend suit or legal proceedings whenever, in its judgment, any interests of the Group Trust require it; and to represent the Group Trust in all suits or legal proceedings in any court or before any other body or tribunal; Group Trust, section 3.2, paragraph (n).

In her July 22, 2011 letter, Ms. Reagan stated that SDCERS believes that the Ordinance violates the Participation Agreement between the City and SDCERS but did not address whether that violation raises constitutional issues. The City Attorney provided no insight on this issue at the first reading of this Ordinance.

SDCERS has now conducted additional research and has concluded that the Ordinance is an unconstitutional impairment of contract under the federal and state constitutions because it is narrowly tailored to modify the terms of the Participation Agreement and Group Trust between the City and SDCERS rather than part of a broad public program which *incidentally* affects the Participation Agreement.

The contract clauses of the federal and state constitutions limit the power of a public entity to modify its own contracts with other parties without their consent. *Board of Administration vs. Wilson* (1997) 52 Cal.App.4th 1109; U.S. Const. art. I, §10, cl. 1; Cal. Const., art. I, §9.

The prohibition against impairment of contracts in the federal and state constitutions is balanced against the public entity's interest in exercising its police power. Where legislation results in a substantial impairment of contracts, that balance requires consideration of five factors: whether the legislation was (1) an emergency measure; (2) to protect a basic societal interest; (3) tailored appropriately to its purpose; (4) imposed reasonable conditions and (5) was limited to the duration of the emergency. When the public entity is itself a party to a contract affected by the legislation, complete deference to the legislature's assessment of reasonableness and necessity is not appropriate because the public entity's self-interest is at stake. *United Firefighters of Los Angeles City v. City of Los Angeles* (1989) 210 Cal.App.3d 1095.

A government's substantial impairment of contract rights is subject to strict scrutiny and the government must show a compelling interest is served by the legislation. "Where an enactment appears to be somewhat narrowly tailored to modify a particular contractual obligation, rather than to be part of a broad public program which incidentally has the effect of impairing the particular contract, it fails the test." *Id.* at 115 (emphasis added).

Because the Ordinance is narrowly tailored to modify the terms of the Participation Agreement and Group Trust document incorporated into that Agreement, it fails the test and is an unconstitutional impairment of the contract between SDCERS and the City of San Diego.

3. Does the Ordinance requiring City consent to settlement put SDCERS' attorney-client privilege in jeopardy when SDCERS seeks that consent?

In her July 22, 2011 letter, Ms. Reagan stated SDCERS' belief that the Ordinance jeopardized SDCERS' attorney-client privilege if SDCERS is required to seek the City's consent on settlement. The letter did not detail the reasons for this belief.

The Ordinance puts SDCERS' attorney-client privilege in jeopardy because SDCERS' request for settlement approval would be required to be presented to the City Council during open session. At first reading of this Ordinance, the City Attorney acknowledged that SDCERS would have to request consent for settlement during open session at City Council meetings but stated, without explanation, that the City would work something out to avoid waiver of the privilege.

The San Diego City Council is a local legislative body subject to the Ralph M. Brown Act ("Brown Act") (Cal. Gov. Code §54951). Meetings of local legislative bodies must be open to the public, unless an exception applies (Cal. Gov. Code §54961). A legislative body may meet in closed session to discuss pending litigation with counsel, but only where discussion in open session would prejudice that local agency's position in the litigation and only where the litigation involves that local agency. Gov. Code §54956.9. Therefore, the City Council could not consider SDCERS' request for settlement approval in closed session.

To support the City's request for settlement approval under the ordinance, SDCERS would need to explain its counsel's reasoning for recommending the settlement, including the strengths and weaknesses of its case. Whether SDCERS provides this information to the City Attorney, or directly to City Council in open session, doing so in a non-joint defense situation could be deemed to waive the attorney-client privilege and subject SDCERS and its counsel to discovery and possible admission at trial concerning the advice given by counsel to SDCERS. Cal. Evidence Code §912, *Klang v. Shell Oil Co.*, (1971) 17 Cal.App.3d 933. Faced with such adverse consequences should the City Council withhold its approval, SDCERS would be unable to settle a case without risking waiver of the attorney-client privilege. This Catch-22 situation presents a serious impediment to the SDCERS Board's ability to settle cases where the best interests of the trust require settlement and thus prevents the Board from fulfilling its constitutional and fiduciary duty to exercise its independent discretion to protect the trust assets.

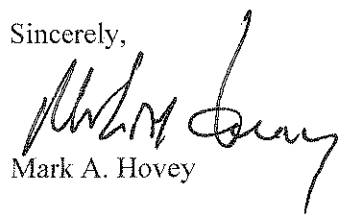
4. Does *Grimm v. City of San Diego* give the City Council power to limit the Board's ability to settle cases?

At first reading of the Ordinance, the City Attorney provided a memo advising the City Council that the *Grimm* case provided authority for the City's limitation of the Board's plenary authority over administration of the System and the trust funds because *Grimm* stated that the City could "control the actions of the Board by ordinance." SDCERS did not address this issue at that time. Upon further review, SDCERS concludes that *Grimm* does not give the City Council power to limit the Board's ability to settle cases for the following reasons:

- **The Ordinance Conflicts with the City Charter:** City Charter section 146 provides that the Council may enact ordinances "to carry into effect" the provisions of the Charter relating to retirement. *Grimm* held that the City could establish a 9-member quorum because the quorum requirement ensured that Board decisions would be representative of a majority of the Board, not just a majority of those present at a meeting and thus effectuated the intent behind City Charter section 144 which sets the composition of the Board. However, the *Grimm* court also noted that while the Council may enact legislation consistent with the Charter, it may not pass any enactment that conflicts with the City Charter provisions. *Grimm v. City of San Diego*, (1979) 94 Cal.App.3d 33, 39. City Charter section 144 provides that the Board has "exclusive control of the administration and investment of such fund or funds as may be established." As explained in #1 above, the Ordinance does not carry into effect but rather conflicts with the City Charter provisions because it seeks to limit the Board's exclusive control over administration of the retirement system. Therefore, *Grimm* provides no authority for the Council to enact this ordinance.
- **The Ordinance Conflicts with the California Constitution:** *Grimm* was decided in 1979 before the 1992 amendments to Cal. Const. art. XVI, section 17 (popularly known as Prop. 162 or the California Pension Protection Act of 1992). As also explained in #1 above, the 1992 amendments grant SDCERS plenary authority. That means the City cannot control the actions of the Board if to do so would interfere with the exclusive authority granted to the Board by the California Constitution and the City Charter.

For all the reasons contained in this letter and in our prior letter of July 22, 2011, SDCERS once again urges you to reconsider this problematic legislation.

Sincerely,



Mark A. Hovey

cc: SDCERS Board of Administration
Honorable Mayor Jerry Sanders
Jay Goldstone, Chief Operations Officer
Julie Dubick, Chief of staff
Jan Goldsmith, City Attorney
William Gersten, Deputy City Attorney
Walter Chung, Deputy City Attorney
Andrea Tevlin, Independent Budget Analyst
Elaine Reagan, SDCERS General Counsel



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July 22, 2011

Honorable Jan I. Goldsmith
San Diego City Attorney
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San Diego, CA 92101-4178

Subject: SDCERS Settlement Authority

Dear Jan:

Thank you for responding to my July 19, 2011 request for a copy of proposed Ordinance O-2012-3 regarding SDCERS' settlement authority, currently docketed on the City Council's July 26, 2011 agenda.

Your July 11 cover memorandum to the proposed ordinance suggests that new powers were extended to SDCERS with the execution of the Group Trust Agreement and that SDCERS spends the City's money without input or oversight. Neither of those statements is accurate. As explained below, SDCERS' authority to settle litigation pre-existed the Group Trust Agreement and SDCERS has and will always consult with the City in advance of settling litigation.

This proposed Ordinance should not be enacted without full consideration of the legal consequences. As has often been said, "Hard facts made bad law." SDCERS urges you to reconsider this Ordinance which, if enacted, may at some future date require further litigation between SDCERS and the City, a result SDCERS fervently wishes to avoid.

I wanted to provide you with some observations and comments on proposed Ordinance O-2012-3 but before doing so will briefly summarize the history leading up to this point, some of which was missing from your July 11, 2011 memorandum.

The impetus for this Ordinance was the City's disagreement over SDCERS' settlement with Ms. Italiano and MEA. (The case arose because the City originally made pension promises to Ms. Italiano that could not be kept. Ms. Italiano and the MEA then sued SDCERS.) The City Attorney's office believes that SDCERS should not have settled the Italiano case because Judge Pressman opined, *after the settlement was negotiated*, that SDCERS was entitled to assert governmental immunities to avoid liability. However, as pointed out in SDCERS' Motion for Good Faith Settlement, SDCERS presented the immunity defenses to the Court when the case was

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first assigned to Judge Hayes, which was *before the settlement was negotiated*. Judge Hayes said that the immunities did not apply. SDCERS was then faced with potential liability exposure at trial and determined, as a reasonable and good faith business decision uninfluenced by emotional or political implications, to settle the case for an amount no greater than the anticipated trial and appeal costs and potential damage awards.

Had the City not objected to the settlement, the City would have realized significant savings in attorney's fees and costs that SDCERS subsequently paid. Unfortunately, the City's efforts to overturn SDCERS' settlement, which the City now admits was within SDCERS' authority, denied SDCERS the benefit of its bargain and caused greater expense to the City, who ultimately pays SDCERS' legal costs.

Prior to entering into the settlement with Ms. Italiano and MEA, SDCERS advised your office of its intention to settle the case and gave your office the opportunity to provide input. When your office offered to take over the defense of SDCERS to avoid the settlement, the SDCERS Board conveyed its willingness to enter into that arrangement provided that three conditions were met: (1) ethical walls were put in place to ensure that no confidential information obtained during the course of that defense was conveyed to other lawyers at the City Attorney's office, which was then and still is actively litigating against SDCERS in other matters; (2) SDCERS would have its in-house counsel act as "shadow counsel" and (3) if a monetary judgment was ultimately entered against SDCERS, the City would not object to payment of that judgment being assumed in the Unfunded Actuarial Assumed Liability ("UAAL"), where its ultimate allocation would be determined by the outcome of the "substantially equal" case.

After receiving SDCERS' response to the City's offer of defense, the City, without explanation, withdrew its offer. Only after seeking the City's input and having the City decline to defend SDCERS did SDCERS settle the case. Subsequent to entering into the Settlement Agreement with Ms. Italiano and MEA, Judge Hayes retired and the case was reassigned to Judge Pressman. It was then, when considering SDCERS' Motion for Good Faith Settlement, that Judge Pressman expressed his view (which was *not* in his final ruling) that the governmental immunities previously denied by Judge Hayes applied to SDCERS.

In April 2011, having agreed that SDCERS has settlement authority, your office requested that SDCERS come to some agreement giving the City the opportunity to object to or approve settlements. The language proposed by your Office, found at page 3 of your July 11, 2011 Memorandum referenced above, went beyond the language contained in the Participation Agreements for the UPD and the Airport, significantly impinged upon the SDCERS Board's plenary authority and presented serious concerns that the concessions sought would jeopardize SDCERS' attorney-client privilege in any litigation it sought to settle. In its response, SDCERS stated that, as it had done in the past; SDCERS would on a case-by-case basis seek the City's input

before settling litigation matters affecting the City. This proposed Ordinance followed that response.

The proposed Ordinance raises many questions, including but not limited to:

- Does the Ordinance violate Article 16, section 17 of the California Constitution? ("Notwithstanding any other provisions of law or this constitution to the contrary the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system"). (Emphasis added.) We believe that it does.
- Does the Ordinance violate Article 16, section 17(a) of the California Constitution? ("The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system.") (Emphasis added.) We believe that it does.
- Does the Ordinance violate San Diego City Charter section 144? ("[The Board] shall have exclusive control of the administration and investment of such fund or funds as may be established" (Emphasis added.) We believe that it does.
- Does the Ordinance violate section 1.2 of the Participation Agreement ("The Plan agrees to abide by the terms of the Group Trust with respect to its participation in the Group Trust.") where the Group Trust gives settlement authority to SDCERS? We believe that it does.
- Does the requirement of City consent to settlement require that the City be named as an indispensable party to the litigation? We have not yet reached an opinion on this issue.
- Does the requirement of City consent to settlement put SDCERS' attorney-client privilege in jeopardy when SDCERS seeks that consent? We believe that it may.

These are the questions and problems which come to mind upon first review of the proposed Ordinance. There may be others we have not yet considered.

The proposed Ordinance further states that the Board will have no authority to settle any litigation involving the payment of funds chargeable to the City "directly or indirectly" through inclusion in the City's ARC or the System's UAAL. This would include any litigation involving SDCERS, whether it involved disputes over benefits with SDCERS members, disputes over payments arising out of SDCERS' contracts or tort claims raised against SDCERS by members of the general public

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such as slip and fall or other types of personal injury claims. We believe this provision is not clear and overly broad.

The proposed Ordinance impinges on the Board's fiduciary duties to protect the trust corpus in that, without City consent, the Board could not settle cases where the Board determines that it is in the best interest of the System to do so. The provision in the Group Trust Agreement allowing the Board to settle claims is consistent with the Board's plenary authority to administer the fund as provided in the California Constitution and the San Diego City Charter as well as the general fiduciary duties of Trustees outlined in the California Probate Code. Trustees have a non-delegable duty to preserve the trust property and take reasonable steps to defend actions that may result in a loss to the trust. (Cal. Probate Code §§ 16006, 16011, and 16012.) Consistent with those duties, Trustees have the power to pay or contest claims, settle claims by or against the trust by compromise, arbitration or otherwise and release any claim belonging to the trust. (Cal. Probate Code § 16242.)

In your Memorandum accompanying the proposed Ordinance, you advise the City Council and the Mayor that the Group Trust Agreement causes the City to "expend sums of money without input or oversight" because of SDCERS' ability to settle claims. Yet, this has always been the case, even before the execution of the Group Trust. Under the provisions of the California Constitution, the City Charter, the Municipal Code and the California Probate Code, SDCERS has always had independent, plenary authority to make decisions concerning payment of benefits, setting of the ARC, entering into contracts and settlement of claims that cause the City to "expend sums of money."

Section 2(f) of the California Pension Protection Act of 1992 (popularly known as Prop. 162 codified in the California Constitution at Article 16, section 17), explains the necessity for independence of the Board: "To protect pension systems, retirement board trustees must be free from political meddling and intimidation." The Board is given this plenary authority so that it may comply with its fiduciary duties as enacted by Prop. 162. The proposed Ordinance clearly acts against the independent balance provided by the California Constitution and the City Charter.

In conclusion, SDCERS has indicated through its words and actions its intent to work with the City now and in the future when resolving litigation. But, the Board cannot delegate to the City veto rights over its fiduciary duty to defend or settle litigation in the best interest of the trust and the City cannot, by Ordinance, interfere with the Board's plenary authority over administration of the trust and trust funds.

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SDCERS urges you to reconsider this legislation.

Sincerely,


Elaine W. Reagan
General Counsel

EWR/mrh

cc: SDCERS Board of Administration
City Council President, Tony Young
Honorable Mayor Jerry Sanders
City Councilmembers
Jay Goldstone, COO
Julie Dubick, Chief of Staff
William Gersten, Deputy City Attorney
Walter Chung, Deputy City Attorney
Andrea Tevlin, IBA
Mark Hovey, SDCERS CEO