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October 29, 2012

Released to public on October 30, 2012 by Contra Costa County Employee's Retirement Association Board of Retirement

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Contra Costa County Employees' Retirement Assn.
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Impact of Assembly Bill 197 on Board Policy re Pensionable Compensation

Honorable Members of the Board:

In September, the California Legislature passed and the Governor signed into law Assembly Bill 197, which changes the definition of "compensation earnable" found in Government Code section 31461, a provision of the County Employees' Retirement Law of 1937 (CERL). By operation of law, the change to the definition of "compensation earnable" will become effective on January 1, 2013.

For the past several years, the Board has acted pursuant to its written policy titled, "Determining Which Pay Items are 'Compensation' for Retirement Purposes" (Policy), to include certain items of accrued leave cash-outs received by members hired before January 1, 2011 in the calculation of their retirement allowances. Specifically, the Board's Policy has allowed inclusion not only of accrued leave sold back during service in certain members' year (or years) used to calculate their retirement allowances, but also amounts of cash they received at termination of employment for additional accrued leave.

You have asked us to advise whether and to what extent AB 197 impacts the Board's Policy and its practices under the Policy.

For the reasons explained below, we advise that on and after January 1, 2013, the Board may no longer include cash-outs for accrued leave in pensionable compensation that exceed the amount that was both earned and payable in cash during each twelve months of the member's "final compensation" period, unless and until otherwise instructed by a court of competent jurisdiction. This new rule is plain from the text of amended section 31461. To the extent the Policy conflicts with the plain meaning of the new statute, the Board and CCCERA staff may no longer implement the Policy.

Accordingly, on and after January 1, 2013:

1. Only members who are entitled to convert accrued leave to cash while still in service, before termination of employment, will have any such amounts included in CCCERA's calculation of their retirement allowances.

2. In calculating retirement allowances, CCCERA may not include more annual leave cash-out amounts than that which was both earned by the member and payable to the member in cash during each twelve months of the member's "final compensation" period.

The language of AB 197 is consistent in this regard with the "Addendum" to the Policy the Board adopted in March, 2010, applicable to employees who first become members of CCCERA after January 1, 2011. In essence, the Legislature has now required the Board to apply its Addendum to the calculation of retirement allowances for all CCCERA members who retire on or after January 1, 2013, not just those employees who become members after January 1, 2011.

BACKGROUND

Determining a Member's Final (Pensionable) Compensation Under CERL

CCCERA has a statutory obligation to pay the proper amount of retirement benefits to each of its members and beneficiaries, as provided by law. It "cannot fulfill [its fiduciary] mandate unless it investigates applications and pays benefits only to those members who are eligible for them." *McIntyre v. Santa Barbara County Employees' Ret. Sys.* (2001) 91 Cal.App.4th 730, 734. In order to discharge that obligation, it is the Board's responsibility to determine the proper elements that go into calculating a member's benefit, as required by the laws governing the retirement system. A CCCERA member's retirement allowance is based, in part, on the member's "final compensation," which is comprised of the member's highest one-year or three-year average "compensation earnable."

In 1997, the California Supreme Court explained: "[T]here is a logical progression in the statutory framework under which a [CERL] pension is calculated. Application of section 31460 is the first step, since an item must meet its broad definition of 'compensation' if it is also to fall within the narrower category of 'compensation earnable' defined in section 31461 and thus form the basis for the calculation of 'final compensation' on which the pension is based pursuant to section ... 31462.1." *Ventura County Deputy Sheriffs' Ass'n v. Bd. of Ret.* (1997) 16 Cal.4th 483, 493-94.

Thus, in order to determine a member's final compensation, the retirement board must go through an ever-narrowing three-step process, which first excludes all non-cash remuneration received by the member (CERL section 31460, defining "compensation"), then excludes remuneration for overtime and payments for services earned outside the final compensation measuring period (CERL section 31461, defining "compensation earnable") and finally, excludes compensation earnable not paid or payable

during the contiguous 365-day year of service chosen by the member (CERL section 31462.1, defining "final compensation period").[1]

Case Law Interpreting CERL and the Contra Costa Paulson Settlement

In *Ventura*, the California Supreme Court ruled that for many years CERL systems had been improperly excluding many items of cash compensation from members' final compensation. Such items included payments for bilingual premium pay, uniform maintenance allowance, educational incentive pay, additional compensation for scheduled meal periods, certain annual leave cash-outs, holiday pay, motorcycle bonus, field training officer bonus and a longevity incentive.

Following *Ventura*, in December, 1997, the CCCERA Board adopted a Policy called, "Determining Which Pay Items are 'Compensation' for Retirement Purposes," (Policy) in order to implement the high court ruling. The Policy itemizes the pay items that would and would not be included when determining a member's final compensation.

Meanwhile, after *Ventura*, litigation arose or was threatened in most CERL counties (including Contra Costa) over (a) several additional pay items that were not specifically addressed in *Ventura*, and (b) whether *Ventura* applied to members who had already retired before the ruling.

The litigation involving CCCERA, the County and CCCERA's participating districts resulted in a court Judgment approving a 1999 settlement agreement, generally referred to as the "*Paulson* Settlement." The treatment of most participating employers' pay codes was specified in exhibits to the Judgment. The CCCERA Policy and the *Paulson* Settlement allow the Board to include in the "compensation earnable" on which "final compensation" is calculated amounts of leave cash-out not only paid during the final compensation period, but also at termination, even if those amounts were not both earned and payable in cash during service in the final compensation period.

Anticipating later legal developments, the *Paulson* Settlement expressly stated: "All Parties agree that any subsequent determinations by a court of competent jurisdiction that enlarge, define, narrow, or in any other way relate to the scope of the decision of the [*Ventura* case] or the items of compensation to be included for benefit purposes under [CERL] shall have no effect on this Settlement or its terms." Thus, the parties to the *Paulson* Settlement (including CCCERA) agreed that, even if a court later ruled that all cash outs of accrued leave paid only at termination should be excluded from final compensation, that ruling would not impact the class members' rights under the settlement to have such cash-outs included if the cashed-out time was earned during the final compensation period. The parties did not, however, attempt to override the impact of future legislative changes to the definition of "compensation earnable."

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[1] Some CCCERA members are subject to the three-year final compensation period under section 31462, in which case their "final compensation" is the average compensation earnable received during each of those final three years. For ease of reference in this analysis, we will refer to a one-year final compensation period. The principles discussed herein also apply to a three-year final compensation period.

A few years later, in the 2003 case, *In re Retirement Cases* (2003) 110 Cal.App.4th 426, the First District Court of Appeal (which reviews appeals from the Contra Costa County Superior Court) explained: "Where an employee cannot or does not elect to receive cash in lieu of the accrued time off *prior to retirement*, the benefit remains one of time rather than cash. The right to a termination pay cash-out arises only upon retirement…; the right does not arise prior to retirement or during service." The court went on to state: "we hold that termination pay that is received upon retirement is not required under CERL to be included in the calculation of pension benefits." *Id.* at 476. The court found this result clear under the statute: *"This language is not ambiguous; it plainly excludes [compensation paid only at] retirement* and we will not rewrite the statute." *Id.* at 475.

In 2004, the appellate court for the Fourth District Court of Appeal (San Diego) addressed the same issue under CERL and ruled in the same way, explaining: "As *In re Retirement Cases* makes clear, a public employer's decision to provide cash reimbursement for unused leave, after separation from service, does not alter the noncash nature of the leave. Such one-time post-termination payments cannot be considered part of final compensation without creating the risk of substantial distortion in the retirement benefits otherwise payable to employees." *Salus v. San Diego County Employees Retirement Assn.* (2004) 117 Cal. App. 4th 734, 741.

Salus went on to observe: "There is nothing in CERL which suggests the Legislature intended pensions should vary so widely on the basis of accrued and unused leave, rather than on the basis of age, years of service and salary." *Id.* at 740. The court's ruling was consistent with its prior ruling on the analogous provisions of the Government Code applicable to CalPERS in *Hudson v. Bd. of Admin.* (1997) 59 Cal. App. 4th 1310, 3121: "The exclusion of final settlement pay from compensation was intended to eliminate distortions…"

After the First Appellate District court approved the *Paulson* Settlement, the CCCERA Board included in the determination of "compensation earnable" cash amounts paid to a retiring member for the value of accrued leave earned during their final average compensation period, regardless of whether paid to the member during service or at termination. This practice applied to all members, regardless of hire date. Then on March 10, 2010, the Board amended its Policy as to employees first becoming members after January 1, 2011 to limit inclusion in "compensation earnable" of only leave cash-out amounts that were both earned and payable to the member during the "final compensation" period, consistent with the appellate court rulings in *In Re Retirement Cases* and *Salus*.

In the current legislative session, the Legislature adopted and the Governor signed into law one far-reaching "pension reform" bill, Assembly Bill 340, and one narrowly targeted bill, Assembly Bill 197. The new legislation goes into effect on January 1, 2013. Unlike many of the provisions of AB 340 that apply primarily to "new employees" or "new members" (as defined), AB 197 contains no such limitations.[2] The bill, as amended, was authored by Contra Costa County Assemblymember Joan Buchanan (D-San Ramon). AB 197 specifically narrows the definition of "compensation earnable" found in CERL section 31461.

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[2] You have not asked us to address AB340's changes that apply to new employees and new members in this letter.

The Board now seeks our advice as to whether and to what extent AB 197 impacts the Board's Policy and its practices under the Policy.

ANALYSIS

Beginning January 1, 2013, as to employees who became members before January 1, 2013, Government Code section 31461 will read, in pertinent part:

> *(a) "Compensation earnable" by a member means the average compensation as determined by the board, for the period under consideration upon the basis of the average number of days ordinarily worked by persons in the same grade or class of positions during the period, and at the same rate of pay. ... Compensation, as defined in Section 31460, that has been deferred shall be deemed "compensation earnable" when earned, rather than when paid.*[3]
>
> *(b) "Compensation earnable" does not include, in any case, the following:*
>
> > *(1) Any compensation determined by the board to have been paid to enhance a member's retirement benefit under that system. That compensation may include: ... (C) Any payment that is made solely due to the termination of the member's employment, but is received by the member while employed, except those payments that do not exceed what is earned and payable in each 12-month period during the final average salary period regardless of when reported or paid.*
> >
> > *(2) Payments for unused vacation, annual leave, personal leave, sick leave, or compensatory time off, however denominated, whether paid in a lump sum or otherwise, in an amount that exceeds that which may be earned and payable in each 12-month period during the final average salary period, regardless of when reported or paid.*
> >
> > ...
> >
> > *(4) Payments made at the termination of employment, except those payments that do not exceed what is earned and payable in each 12-month period during the final average salary period, regardless of when reported or paid.*
>
> *(c) The terms of subdivision (b) are intended to be consistent with and not in conflict with the holdings in* ***Salus v. San Diego County Employees Retirement Association*** *(2004) 117 Cal.App.4th 734 and* ***In re Retirement Cases*** *(2003)110 Cal.App.4th 426.*

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[3] The language of new subsection (a) remains unchanged from the current text of Section 31461. AB 197 added subsections (b) and (c) to the statute.

When the changes to CERL section 31461 become effective on January 1, 2013, they will then begin to govern CCCERA's calculation of "compensation earnable" for determining pensionable compensation of its retiring members. CCCERA will need to follow the new terms for all current active members who retire on or after that date.

The plain terms of AB 197's amendments to CERL section 31461 (specifically, subsections (b)(2) and (4)) expressly require the Board to exclude from members' "compensation earnable" any amounts for unused leave time either paid during service or paid only at termination, unless those payments were both earned and payable in cash during the "final compensation" period. To the extent the Policy is inconsistent with the new provisions of law, CCCERA may no longer implement the Policy.

Accordingly, beginning January 1, 2013, the following changes will need to be made with respect to CCCERA's current practices under the Policy for members who were hired before January 1, 2011, under the plain and unambiguous terms of section 31461:

1. CCCERA may no longer include any annual leave cash-out received by a member only at termination, because such cash was not "payable" to the member in cash during service in the "final compensation" period.

2. CCCERA may no longer include any amount of annual leave cash-outs that exceeds the amount that was both earned and payable to the member in cash while in service during the final compensation period.

These changes affecting the definition of "compensation earnable" are consistent with the Addendum to the Policy adopted by the Board on March 10, 2010, as applicable to employees first becoming members on or after January 1, 2011. In essence, the Board will now be required to apply the Addendum to all members retiring after January 1, 2013, the effective date of AB 197.

In its 2011 filing for a favorable determination by the Internal Revenue Service of its continued status as a tax-qualified governmental pension plan under section 401(a) of the Internal Revenue Code, CCCERA represented to the IRS that the CERL was its core "plan document." In order to preserve its tax-exempt status, CCCERA has been advised by its tax counsel that it must continue to operate consistently with its plan document. Accordingly, the Board has no discretion to depart from the plan meaning of the terms of the CERL, as amended from time to time by the California Legislature. To do so could expose the system, its employers and its members not only to taxation on contributions made into the system and all investment income earned on those contributions, but to severe penalties and interest as well.

We recognize that there are questions concerning the enforceability of AB 197 as to CCCERA members who were hired before January 1, 2011. California case law precedent exists which affects the Legislature's right to alter the "vested retirement benefits" of current employees, under the broad prohibition against the impairment of contracts found in both the California and United States constitutions. This letter expresses no opinion regarding how the courts ultimately might rule in the future if affected members present such questions for judicial resolution. We simply note that regardless of such questions, California law does not permit a local governmental agency, such as CCCERA, to unilaterally disregard the plain language of the governing law it is charged with administering, as duly

enacted by the Legislature and signed into law by the Governor, and refuse to implement it. Determining the constitutionality of a state statute is a role exclusively conferred by the People on the judicial branch. Unless and until a court of competent jurisdiction orders otherwise, local public officials are required to follow the directives of their governing statutes.

This principle was clearly enunciated by the state Supreme Court in *Lockyer v. City and County of San Francisco* (2004) 33 Cal.4th 1055. In that case, the California Supreme Court analyzed a claim by city officials that those officials could issue marriage licenses to same-sex couples, in violation of the plain terms of a California statute requiring marriage to be between only members of the opposite sex. The city officials argued they could do this because they had concluded the statute at issue likely violated the California Constitution. *The Supreme Court unanimously held that local officials have no authority to disregard the plain terms of a California statute, based on those officials' conclusion that the statute may be unconstitutional.*

By analogy, Art. III sec. 3.5 of the California Constitution provides:

> *An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power:*
>
> *(a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional;*
>
> *(b) To declare a statute unconstitutional;*
>
> *(c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.* [4]

The California Supreme Court's opinion in *Lockyer* is particularly instructive given that just four years later, the California Supreme Court ruled that the city officials actually had been correct in their conclusion that the statute at issue violated the California Constitution. *See In re Marriage Cases*

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[4] *Valdes v. Cory* (1983) 139 Cal. App. 3d 773 applied Art.III sec. 3.5 to the Board of Administration of CalPERS, a state agency. The Supreme Court in *Lockyer*, however, expressly declined to rule on whether Art. III sec. 3.5 applies to local governmental agencies, such as CCCERA, as well as to state administrative agencies: "[W]e have determined that we need not (and thus do not) decide in this case whether the actions of the local executive officials here at issue fall within the scope or reach of article III, section 3.5, because we conclude that prior to the adoption of article III, section 3.5, it already was established under California law – as in the overwhelming majority of other states…– that a local executive official, charged with a ministerial duty, generally lacks authority to determine that a statute is unconstitutional and on that basis refuse to apply the statute. …[T]he adoption of article III, section 3.5 plainly *did not grant or expand* the authority of local executive officials…" 33 Cal. 4th at 1085-86.

(2008) 43 Cal. 4th 757. Nevertheless, it is the courts, not local governmental agencies, that have the authority to make that determination.

Accordingly, we have clear guidance from the California Supreme Court that a local agency, like the CCCERA Board, must follow the plain terms of the governing statute it is charged with administering, like section 31461, even if the Board reasonably believes that statute later may be found to be unconstitutional.

CONCLUSION

For the reasons explained above, we advise that on and after January 1, 2013, the Board may no longer include cash-outs for accrued leave in pensionable compensation that exceed the amount that was both earned and payable to the member in cash during each twelve months of the member's "final compensation" period, unless and until otherwise instructed by a court of competent jurisdiction. This new rule is plain from the text of AB 197's amendment to CERL section 31461. To the extent the Board's policy for "Determining Which Pay Items are 'Compensation' for Retirement Purposes," conflicts with the plain meaning of the new statute, the Board and CCCERA staff may no longer implement the Policy.

Accordingly, on and after January 1, 2013:

1. Only members who are entitled to convert accrued leave to cash while still in service, before termination of employment, will have any such amounts included in CCCERA's calculation of their retirement allowances.

2. In calculating retirement allowances, CCCERA may not include more annual leave cash-out amounts than that which was both earned by the member and payable to the member in cash during each twelve months of the member's "final compensation" period.

Thank you for the opportunity to advise the Board on this matter.

Respectfully,

Harvey L. Leiderman

cc: Marilyn Leedom, Chief Executive Officer
Karen Levy, General Counsel