Thank you for the opportunity to testify before you today. My name is Jennifer Baker. I am a Legislative Advocate for the California Teachers Association. I am presenting on behalf of the CTA and as Chair of the California Retirement Coalition, which is comprised of various labor and management organizations whose members belong primarily to the California State Teachers Retirement System.

The members of the California Retirement Coalition include: the Association of California School Administrators, the California Association of School Business Officials, the California Federation of Teachers, the California Retired Teachers Association, the California School Boards Association, the Community College League of California, Delta Kappa Gamma, the Faculty Association of California Community Colleges, the Los Angeles Community College Faculty Guild, the Los Angeles Unified School District, and the United Teachers of Los Angeles.

We appreciate the enormous task before you and recognize the difficulty in what you are seeking to accomplish by creating uniform accounting standards and appreciate the fact that you have been undertaking this task in a transparent, methodical manner.

While you have been discussing the accounting methodologies of pension liabilities, we in California, have been facing a budget crisis of historic proportions, which has decimated educational funding. Unfortunately, we also realize that we are not the only state that is in this situation.

We have been working in concert with our State’s leaders on ways to find both short and long-term ways of resolving our economic situation; we have also been discussing ways of addressing the long-term funding needs of the CalSTRS system, which has an unfunded actuarial obligation of over $54 billion. This shortfall originated with the dot com bust and was exacerbated by the recent economic decline our nation has been facing.

This shortfall is projected on a 30-year basis and will need an infusion of additional contributions and a steady stream of solid returns by the stellar investment team at CalSTRS. Coupled with our budget situation, I am sure you can realize that this is a daunting task, but it is a task that all of our stakeholders recognize is of significant importance for our educational system and California’s economy.

In your series of recommendations, you propose to recognize the CalSTRS unfunded obligation on the financial statements of local school and community college districts. While many local employers in other states are the guarantor’s of the retirement systems their members participate in, the CalSTRS system is somewhat different in the fact that the State is the guarantor of the plan, as specified in the California Constitution. As such, the Teachers Retirement Board, which oversees CalSTRS, does not have authority to set contribution rates or the plan design; they are set by the Legislature and Governor.
By changing accounting standards in the manner proposed, the current CalSTRS unfunded actuarial obligation, which is currently not recognized on any financial statements, will be placed on the financial statements of hundreds of school and community college districts across the state, which, administratively will be significantly burdensome for those districts, as well as CalSTRS, to technically implement.

Of greater importance, is the practical fiscal and policy impact this will have on California’s educational system at the local level. Local school and community colleges continue to face unprecedented cuts totaling $18 billion over the last three years, which has resulted in the loss of tens of thousands of educators in both K-12 and community college districts. Class sizes have dramatically increased and traditional programs like art, music, P.E., summer school and career technical education programs have been decimated, leaving the kindergarteners of today to face an educational system eroded by budget cuts.

The reason your proposal to show the unfunded liability at the local level, rather than the State, is of such significance is because when you made previous accounting changes in regard to retiree health care it resulted in a reduction of retiree health care being offered to teachers. CalSTRS has conducted two studies that have shown decreases in retiree health care offered. As a result, most teachers after age 65 do not receive health care. This fact, along with the fact that teachers do not receive Social Security and have an average retiree benefit of $3,300 a month has led to a less than humble retirement situation for teachers who are also burdened with increased health care costs.

Educational leaders are just beginning to digest the enormous impact your proposed changes will have at the local level as their gaze has been focused upon keeping school districts afloat. Should you move forward on your current time schedule, school districts will need to begin to prepare now to be able to be ready for the new standards. This will need to be done at the same time they are trying to anticipate if they will face additional budget cuts and will need to plan with reduced staff and resources. Should the timelines you are considering be extended for a year, this would give educational leaders more time to prepare local districts for what they will need to anticipate and to also create best practices for how to implement it.

While your focus is pension accounting methodology, please understand that these changes could lead to policy changes at the state and local level which can have a major impact on California’s educational structure. School and community college leaders are not versed in CalSTRS and the California Public Employee Retirement System other than knowing that their payroll departments take the necessary deductions from employees paychecks and that the service credit earned by those employees is reported to these systems.

There are many additional layers of discussion and implementation that will need to occur at the local level which will necessitate the involvement of all of the players, including: school board members, superintendents or chancellors, school budget officials, educators and classified faculty. The individuals that will be involved with this process are not experts in accounting or pension liabilities and will need an opportunity to become more familiar with the dynamics of the discussions. Should these issues
move forward before the climate is ready, it can lead to misinterpretations of what is required, which is what happened in the past with implementing accounting changes to retiree health care liabilities.

We are asking you to: First, consider extending these discussions for a year or more to give us the necessary time to educate and prepare for any possible accounting changes; Second, to give states and local governmental entities the ability to have their constitutionally mandated guarantor as the entity that will be required to show their pension liabilities in their financial statements; Third, we support the additional issues CalSTRS is recommending to change and are working with CalSTRS in a dialog on these issues.

As we continue to discuss the practical aspects of how your recommendations would be implemented, we would be happy to communicate issues of interest to you and how these changes could lead to policy changes as a result.

I appreciate the opportunity to share our views on these important issues and would be happy to answer any questions that you may have.
October 12, 2011

Mr. David R. Bean  
Director of Research and Technical Activities  
Project Nos. 34-E and 34-P  
Governmental Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Response to GASB Exposure Draft for Amendments to Statement Numbers 25 and 27

Dear Mr. Bean:

The California Teachers Association (CTA) appreciates the opportunity to share with you perspectives on both practical and policy impacts your proposed accounting changes may have on schools and community college districts throughout the state of California.

The CTA includes teachers, counselors, school librarians, social workers, psychologists, and nurses. These educators in the K-12 school system are joined by community college faculty, California State University faculty, and education support professionals. The majority of CTA members belong to the California State Teachers’ Retirement System (CalSTRS) by virtue of their working as K-14 educators.

We appreciate the enormous task before you and recognize the difficulty in what you are seeking to accomplish by enhancing accounting standards for employee pensions and are also appreciative of the opportunity to provide input to your deliberations.

While you have been discussing accounting methodologies of pension liabilities, California has been facing a budget crisis of historic proportions, which has decimated educational funding. Unfortunately, we also realize that we are not the only state that is in this situation.

The CTA has been working in concert with our State’s leaders on ways of finding both short and long-term solutions for resolving our economic situation; we have also been discussing possibilities for addressing the long-term funding needs of the CalSTRS system, which has an Net Pension Liability (NPL) of over $56 billion, which originated with the dot com bust and has been exacerbated by the recent economic decline that our nation, and now the globe is facing.

Ultimately, your recommendations seek to ensure pension liabilities, such as the shortfall faced by CalSTRS, receive the proper attention and scrutiny they deserve to better strengthen those systems nation-wide.
In review of your proposed accounting changes, the CTA believes that, in regard to the CalSTRS system, and its pension liabilities, these proposed changes would result in less transparency, less accountability and less decision-usefulness while creating significant implementation challenges.

Implementation Challenges

CalSTRS receives data on employee compensation monthly from school and community college districts. However, there is approximately a two month lag-time in reporting from the district to CalSTRS. Thus, data reported by the school or community college district for employee compensation for the end of the fiscal year, June 30, would not be received by CalSTRS until sometime in August. CalSTRS must then check and post the data. This puts the earliest possibility for CalSTRS to report back to these districts into October.

School and community college districts must prepare their financial reports for the State during June, July, and August. For the K-12 system, the County Offices of Education must receive the reports after local school boards have approved the fiscal report by September 15 each year. Thus, it won’t be possible to accurately report in a timely fashion each year of the potential CalSTRS NPL to be included in the districts fiscal reports.

The administrative burdens that will be faced by the California Public Employees Retirement System (CalPERS), which is the system that serves non-credentialed educational support personnel, may be as severe and the cost of compliance may have a significant impact on employers which could take additional resources to implement, further eroding funding that would go to serve children.

Less Transparency/Accountability

The CalSTRS system is managed by the Teachers’ Retirement Board, whose role is to set policies and rules as well as to ensure benefits are paid to its’ members. The contribution rates and benefits are set in statute by the California Legislature and Governor, who are also responsible as the guarantor of the CalSTRS system by virtue of statute and case law (Leiderman, 2010). As such, the State is responsible for showing the current NPL CalSTRS faces on their ledger. As the ultimate guarantor, this transparency is clear.

Should the reporting entity shift from the State to the hundreds of local school and community college districts, the public oversight for pension costs will be spread across the state to entities that have no historical or practical knowledge of reporting pension costs. This shift will deceive the local school and community college districts, and those that work with them at the local level, to believe they have become responsible for the pension liabilities. By spreading out the pension liabilities to those whom are not the guarantors of the retirement plan, transparency will be muddled by moving from one reporter to hundreds of reporters.
Mr. David Bean  
October 12, 2011  
Page 3

This shift could have a practical impact on local school and community college boards who may seek to eliminate their pension obligations to protect local programs, not realizing that the accounting rules are for reporting purposes only. This was the case when the rules regarding retiree health care were changed by previous accounting standards. Educators in California saw a decrease in the amount of school and community colleges that provided retiree health care, which has resulted in the policy outcome of most retired educators facing their retiree years without retiree health care after age 65.

**Less Decision-Usefulness**

The purpose of being transparent in reporting pension obligations is to ensure that these obligations are properly cared for by decision-makers and those that will review those obligations in order to make judgments as to their soundness. For example, Moody’s will evaluate CalSTRS’ NPL in context of other liabilities faced by the State to determine what the State’s bond ratings should be. Should the State fall silent on their pension liability for CalSTRS as proposed in your new rules, will it not shield these obligations from Moody’s in a manner that will not allow Moody’s to properly evaluate all the State’s obligations? This is also the case at the local level for school and community college districts. Will school and community college districts be impacted by CalSTRS pension liabilities they are not ultimately responsible for by such entities as Moody’s if they sold local bonds for school and community college construction?

Conversely, all liabilities are reviewed when a school or community college is evaluated for accreditation. The Western Association of Schools and Colleges evaluates school financial records and would not inherently know that pension liabilities are ultimately the responsibility of the State when evaluating schools’ or community colleges’ finances for accreditation purposes. Wouldn’t the addition of pension liabilities these schools are not ultimately responsible for make it harder for an accreditation entity to make proper decisions regarding the levels of fiscal strength a school or community college possesses?

Further, while not all charter schools are part of CalSTRS, many are. Will those charter schools that are part of CalSTRS also be subject individually to the proposed new rules, or will the reporting fall upon the district in which the charter resides? Who would be responsible for State-created charter schools reporting?

The educational system in California is complex, with many layers. In order to apply new rules it is imperative that clarity in all regards is given in order to eliminate increased levels of complexity. With a multitude of issues surrounding the fiscal environment of California, it is extremely important to understand and evaluate any new rule that may impact the already complex environment. Nevertheless, the CTA supports creating mechanisms that ensure transparency, accountability and better decision-making.
Mr. David Bean  
October 12, 2011  
Page 4

The CTA believes the proposed changes you are considering may hamper California’s attempts at transparency, accountability and decision-making at both the State and local level. We ask you to: first, consider extending these discussions for a year or more to give us the necessary time to garner clarity of the full impact of these proposed changes, as well as to educate ourselves and others and to prepare for any possible accounting changes; second, we ask that you give states and local governmental entities the ability to have their mandated guarantor as the reporting entity for pension liabilities; and, third, we ask that you continue to collaborate with CalSTRS on the additional issues CalSTRS is both recommending and seeking clarity on as you move forward.

As we continue to discuss the practical aspects of how your recommendations would be implemented, we would be happy to communicate issues of interest to you and how these changes could lead to additional policy changes.

Thank you for the opportunity to share our views on the proposed accounting changes you are considering. Feel to contact me at ibaker@ctaa.org or at (916) 325-1500 should you have any additional questions or concerns.

Sincerely,

Jennifer Baker  
Legislative Advocate

cc: California Governor Jerry Brown 
California Senate President Pro Tem Darrell Steinberg 
California Assembly Speaker John Pérez 
CalSTRS CEO Jack Ehnes 
CalSTRS Deputy CEO Ed Derman 
CTA Associate Executive Director Joe Nuñez 
CTA Legislative Relations Manager Lori Easterling

Attachment

JH/bs
GK/\1\Jennifer B\1\2011 Misc. Documents\GASB\CTA GASB Letter.docx
10/12/11
I. PURPOSE

This item is intended to provide the Board with a detailed description of the legal parameters to consider as it addresses issues arising from the unfunded liability.

II. RELATIONSHIP TO THE BOARD’S STRATEGIC PLAN

<table>
<thead>
<tr>
<th>Goal</th>
<th>Objective</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>D</td>
<td>Ensure a financially sound retirement system through adequate contributions and optimal investment returns.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Develop and implement a full funding plan.</td>
</tr>
</tbody>
</table>

III. BACKGROUND AND DISCUSSION

The California State Teachers’ Retirement System (“CalSTRS”) administers a defined benefit public employees’ pension program, serving over 847,000 active, inactive and retired teachers and their beneficiaries. CalSTRS’ governing body, the Teachers’ Retirement Board (“board”), has exclusive and plenary authority to administer and invest the assets of the fund in a manner that will assure the prompt delivery of the benefits and other services promised to the members and beneficiaries of the system.

Based on current assumptions and projections as of June 30, 2009, the system faces an unfunded actuarial liability of approximately $40.5 billion, resulting in a funding ratio of about 78 percent. Based on the market value of assets as of that date, however, CalSTRS has determined that the unfunded liability would increase to $73 billion and the funded ratio would be approximately 58 percent. CalSTRS currently projects that, given present investment return and contribution assumptions, the fund will be fully depleted in about 30 years.

The board also has been advised by its external actuary consultant that if contributions and benefits remain unchanged, there is only a ten percent chance that investment returns will sufficiently exceed the assumed eight percent return over the next thirty years to fully fund its obligations.
The funding challenges raise the following issues:

A. What are the current benefits promised to CalSTRS’ members and what contribution mechanisms are in place to fund those benefits?

B. Could members’ benefits be modified to help mitigate current and future funding challenges?

C. What are the school employers’ funding obligations with respect to the long term financial health of the system?

D. What are the State’s funding obligations with respect to the long term financial health of the system?

E. What is the board’s role in addressing these funding challenges?

A. **Current CalSTRS Members’ Benefits and Contribution Mechanisms**

1. Current CalSTRS Members’ Benefits

   a. **Basic Retirement Benefit.** Under Education Code section 24202, members receive retirement allowances based on a formula that includes an age factor, years of credited service, and final compensation, commonly known as “2 percent at 60.”

   b. **Disability Retirement.** Disability allowances are governed by sections 24001 et seq. for members who joined CalSTRS before October 16, 1992. Disability allowances are governed by sections 24100 et seq. for members who joined CalSTRS on or after October 16, 1992 (and for other existing members as of that date who elected the changed benefit structure).

   c. **Improvement Factor.** Under section 24402, most payments to members and survivors are increased by application of a benefit “improvement factor.” Section 22140 defines the “improvement factor” as an annual increase of two percent in monthly allowances. Pursuant to subdivision (b) of that section, however, the improvement factor may not be compounded and the “Legislature reserves the right to adjust the amount of the improvement factor up or down as economic conditions dictate. Any adjustment of the improvement factor may not reduce the monthly retirement allowance or annuity below that which would be payable to the recipient under this part had this section not been enacted.” (There are also numerous specific benefit improvements and benefit minimums that apply to specific subgroups of long-retired members in sections 24400 et seq.)
d. **Supplemental Benefit Maintenance Account (SBMA).** Under sections 24415 and 24415.5, funds in the SBMA are paid to retired members whose purchasing power has eroded to below 85 percent (or 80 percent depending upon the sufficiency of the funding in the SBMA). Based on the plain terms of section 24415 (and other related statutes) as well as the *Genest* case, members do not have vested rights to this purchasing power protection, but they do have vested rights to both (a) the state’s required contributions to the SBMA and (b) purchasing power protection, when funds exist in the SBMA. Also, CalSTRS may require employers to make additional contributions (subject to approval by the Legislature) if the funds in the SBMA are insufficient to keep members’ purchasing power at 80 percent or greater.

e. **Medicare Part A Premium Payment Program.** Under section 25940, CalSTRS is required to pay Medicare Part A premiums for qualified members who retired prior to 2001 and has discretionary authority to extend these payments to certain qualifying members who retired after January 1, 2001, if funds are available to do so. To date, the board has extended the benefit to those who retire prior to July 1, 2012.

f. **Death and Survivor Benefits.** Sections 23801, 23851 and 23880 provide for one time death and monthly survivor benefits. The amounts are set by statute, but the board has discretionary authority to adjust one-time amounts “based on changes in the All Urban California Consumer Price Index.”

g. **Defined Benefit Supplement Account.** Under section 22901.5, one quarter of the 8 percent contributed by a member pursuant to Section 22901 is credited to the member’s Defined Benefit Supplement account. The amount in that account is paid to the member in a lump sum, annuity payments or a combination of the two, at retirement. Section 22901.5 is only operative through 2010, absent further action by the Legislature. In addition, Section 22905 requires that member and employer contributions on compensation paid for a limited number of times or for service in excess of one year in a school year be credited to the account. Those contributions have no sunset date.

2. **Current Contribution Mechanisms**

a. **Member Contributions.** Under section 22901 “Each member of the Defined Benefit Program shall contribute to the retirement fund an amount equivalent to 8 percent of the member’s creditable compensation.” Under section 22901.3, however, contributions from a “state employee” in the DB Program, such as certain employees with the Department of Education or the California Community College Chancellor’s Office, are subject to collective bargaining and the contributions of officers or employees of the executive branch (who are not otherwise “state
employees" and are not members of the civil service) are established by the Director of the Department of Personnel Administration.

b. **Employer Contributions.** Pursuant to sections 22950 and 22951, employers contribute 8.25 percent of the creditable compensation upon which members’ contributions are based. Under sections 22951.5 and 24416, the board may increase employer contributions (subject to limits and approval of the Legislature) if the board determines that the SBMA does not have sufficient funds.

c. **State Contributions.**

1) Under section 22955, the State makes a continuous annual appropriation of 2.017 percent of total creditable compensation, plus as much as 1.505 percent more, if necessary, “to reflect the contribution required to fund the normal cost deficit or the unfunded obligation [related to the benefit plan in effect as of July 1, 1990] as determined by the board based upon a recommendation from its actuary.”

2) Under section 22954 and 22954.5, the State is also required to make an annual appropriation to the SBMA of 2.5 percent of total creditable compensation. That appropriation is subject to a statutorily imposed reduction (by $71 million for 2010-11, and by $72 million annually thereafter). The state is also required to appropriate payments on the *Genest* Judgment of about $57 million per year through 2012-13.

### B. **Legal Limitations on Modification of Member Benefits**

Article I, section 10, clause 1 of the United States Constitution provides: “No State shall ... pass any ... Law impairing the Obligation of Contracts.” Similarly, Article I, section 9 of the California Constitution provides: “A ... law impairing the obligation of contracts may not be passed.”

California has a strong public policy, enunciated through published legal decisions over the past half century, establishing the sanctity of public employee retirement benefits as contractual obligations entitled to Constitutional protections. This is unlike some states, which view pensions as “gratuities” that can be altered at any time by the state.

These constitutional principles have been applied in numerous California appellate opinions, including several published opinions regarding CalSTRS’ members specifically. Under those cases, the following general principles emerge:
Regular Meeting – Item 2  
September 3, 2010 
Page 5

1. A public employee obtains a vested right to the provisions of the applicable retirement law during his or her public employment. Promised benefits may be increased during employment, but not decreased.

2. The same rules apply to all active members whether or not they have performed the requirements necessary to qualify for certain benefits that are part of the applicable retirement law. For example, even if a member has not yet performed the five years of creditable service that is ordinarily required to receive a service or disability retirement, the member’s right to qualify for those benefits upon performance of five years of service cannot be taken away. See, e.g., Frank v. Board of Administration (1976) 56 Cal.App.3d 236, 242 (“Even before the happening of the contingency that makes the pension payable, the right vests when the employee performs services under a law specifying his compensation.”) The California Supreme Court has explained:

We have [ ] held that the right to pension benefits vests upon the acceptance of employment, even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied. As we stated in Kern, “It is true that an employee does not earn the right to a full pension until he has completed the prescribed period of service, but he has actually earned some pension rights as soon as he has performed substantial services for his employer. He is not fully compensated upon receiving his salary payments because, in addition, he has then earned certain pension benefits, the payment of which is to be made at a future date. While payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.”


There is one narrow exception to the constitutional prohibition against the impairment of contracts. Both the California and United States Supreme Courts have held that “a substantial impairment may be constitutional if it is ‘reasonable and necessary to serve an important public interest.’” However, the courts do not defer to a “legislative assessment of reasonable and necessity,” because “the State’s self-interest is at stake [and a] governmental entity can always find a use for extra money, especially when taxes do not have to be raised.” Instead, the courts apply a rigorous four-prong test when applying this limited exception: (1) the enactment must serve to protect “basic interests of society”; (2) there must be an “emergency justification for the enactment”; (3) the enactment must be “appropriate for the emergency;” and (4) the enactment
must be “designed as a temporary measure, during which time the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment.” Valdes v. Cory (1983) 139 Cal.App.3d 773, 790.

3. Retirees and inactive members have a vested right to the benefits that were in place when they were employed. But they do not have vested rights to any beneficial changes in the law that apply to allowances after their employment, because a “member whose employment terminated before enactment of a statute offering additional benefits does not exchange services for the right to the benefits.” Claypool v. Wilson (1992) 4 Cal.App.4th 646, 662.

There is an exception when the retiree or inactive member gave up another right acquired during service specifically in exchange for the right to receive post-employment improvements. See, e.g., Pasadena Police Officers Association v. City of Pasadena (1983) 147 Cal.App.3d 695, 706-07.

4. Future employees have no vested rights to any particular retirement benefits because they have not yet entered into public employment. See, e.g., Cal. Assoc. of Prof. Scientists v. Schwarzenegger (2006) 137 Cal.App.4th 371 (“future employees do not have a vested right in any particular pension plan.”)

5. Active public employees have a vested right to a substantial pension, but, under appropriate circumstances, the terms of their retirement rights may be modified prior to retirement.

Multiple California published decisions discuss the circumstances under which modifications (impairments) to the rights of active employees are permitted. In these decisions, several themes emerge:

(a) The nature of the contractual rights must be analyzed to see if the operative law contemplates changes or expressly reserve the right to modify or eliminate certain benefits. For example, as mentioned previously, in Education Code section 22410, subd. (b) the Legislature reserved the right to adjust the annual 2 percent adjustment as economic conditions dictate.

However, if member contributions are fixed at a particular percentage level, then the impacted employees have a vested right to that contribution level. Pasadena Police Officers Ass’n v. City of Pasadena, supra, 147 Cal.App.3d at 702-03 (“where the employee’s contribution rate is a fixed element of the pension system, the rate may not be increased unless the employee receives comparable new advantages for the increased contribution.”). This is the situation that exists with respect to current member contributions to the Defined Benefit Program, in which the law does not provide for increasing that contribution rate. The employer (or Legislature) may not fill
funding shortfalls by increasing member’s contributions. See, e.g., Association of Blue Collar Workers v. Wills (1986) 187 Cal.App.3d 780).

(b) If a vested right is impaired, the next question is to determine whether the change had a “material relation to the theory of a pension system and its successful operation.” Changes made to effect economies and save the employer money have been held to bear some material relation to the theory of a pension system and its successful operation. Claypool v. Wilson (1992) 4 Cal.App.4th 646, 666.

(c) If both (a) and (b) have been met, the next factor is whether the impacted employees have received a “comparable new advantage.” This analysis involves looking specifically at what has been taken from and provided to the impacted employees on an individual basis. Betts v. Board of Administration of Public Employees’ Retirement System (1978) 21 Cal.3d 859, 864 (“The comparative analysis of disadvantages and compensating advantages must focus on the particular employee whose own vested pension rights are involved.”) This often leads to different analyses for different employees based on their hire date. See, e.g., Pasadena Police Officers Association v. City of Pasadena, supra, 147 Cal.App.3d at 695 (analyzing rights of different members by date of hire).

(d) When employees have vested rights to benefits, those rights necessarily are accompanied by a vested right to a financially sound retirement system that will be able to honor the obligation to pay those benefits. This is evident from the Teachers Retirement Law, Education Code section 22000 et seq. (“TRL”) itself (e.g., sections 22001 and 22955(d)), as well as published law. The court applied this concept specifically to CalSTRS in California Teachers Association v. Cory (1984) 155 Cal.App.3d 494, 506, explaining: “Given [the] commitment to permanency of funding and the critical importance which funding bears to the capacity of the state to fulfill the underlying contractual promise to pay the pensions, we imply a promise of funding in exchange for the valuable services rendered by the state’s teachers.” See, also, Board of Administration v. Wilson (1997) 52 Cal.App.4th 1109, 1133 (“Actuarial soundness of [CalPERS] is necessarily implied in the total contractual commitment, because a contrary conclusion would lead to express impairment of employees’ pension rights.”) Employees have a vested right to the statutorily required employer contributions to the retirement system – even if those contributions are not required for actuarial soundness.

6. The Legislature’s ability to alter members’ vested rights is subject to substantial limitations. Based on the “vested rights” cases described above, CalSTRS’ members can be said to have three substantive, and independent, vested rights:
Regular Meeting – Item 2  
September 3, 2010  
Page 8

(1) the benefit and contribution structure in place during the time of employment;

(2) a financially sound retirement fund; and

(3) specific appropriations to the fund from the Legislature.

Each is protected from unlawful “impairment” and therefore none can be sacrificed to satisfy another. For example, under California law, members’ vested rights to benefits cannot be reduced in order to improve the funded status of the retirement system as a whole, even if the system is suffering what some might refer to as an “actuarial emergency” (a term recently used in Colorado to describe the funding problems of its state employees’ retirement system). This applies to both benefit levels (such as “2 percent at 60”) and contribution levels. Thus, existing CalSTRS members subject to the flat 8 percent employee contribution rate have a vested right to an 8 percent contribution rate under Education Code section 22901, and that rate cannot be increased without providing a compensating new advantage to the members.

Temporary impairment of members’ vested rights may be permitted in a true emergency circumstance, but that emergency would have to be far more pervasive and egregious (war, epidemic, natural disaster or total collapse of the State’s finances) than a funding problem at CalSTRS. See Board of Administration v. Wilson (1997) 52 Cal.App.4th 1109 (“fiscal emergency” did not justify failing to pay required contributions to CalPERS). Further, since the impairment must be temporary and members would be entitled to interest once the temporary impairment ended, use of this limited exception to the constitutional contracts clause protections is not available as a long term strategy to deal with chronic or projected funding shortfalls.

In sum, no matter how dire the funding situation of the system may be, the response must be for the Legislature to solve the problem by (a) increasing CalSTRS’ funding in order to make the system financially sound, through increased State and employer contributions or increased contributions of new members who do not have a vested right to the 8 percent contribution level currently in place, and/or (b) decreasing non-vested benefits.

The Legislature does have broad discretion, however, to alter non-vested benefits at any time for any reason. The determination of whether a benefit is vested or non-vested may require a substantial factual inquiry that analyzes the history of collective bargaining, the legislative process, actions by the board and related legal actions.

C. The School Employers’ Funding Obligations

Pursuant to sections 22950 and 22951, school employers must contribute 8.25 percent of the creditable compensation upon which members’ contributions are based. Additionally, under sections 22951.5 and 24416, the board may increase employer contributions (subject to limits
and approval of the Legislature) if the board determines that the SBMA does not have sufficient funds.

The employers’ funding obligations are stated in mandatory terms (employers “shall” contribute). Thus, employers have no discretion to cease paying the full contributions required of them. See, e.g., Teachers’ Retirement Bd. v. Genest (2007) 154 Cal.App.4th 1012, 1036 (“withholding statutorily mandated sums [to CalSTRS]… is an impairment of contract.”); Cal. Teachers Ass’n v. Cory (1984)155 Cal.App.3d 494, 508-10 (same).

Thus, the school employers are not obligated to sufficiently fund the system; their obligation is to provide the contributions specified by statute. It would require a modification of existing statutes to change that rate.

D. The State’s Funding Obligations

The State’s obligation to fund the vested benefits of CalSTRS’ members and their beneficiaries is not limited to the amount of money in the trust fund from time to time. The California Supreme Court has explained that when retirement laws “can reasonably be construed to guarantee full payment to those entitled to its benefits regardless of the amount in the fund established by the pension plan, then we are, of course, required to construe the provision liberally in favor of the [pensioner] so as to carry out their beneficent policy.” Bellus v. City of Eureka (1968) 69 Cal.2d 336, 351. The Court then went on to explain: “It obviously would be unjust to make the payment of pensions dependent upon the solvency of a particular fund, thereby depriving employees of the benefits of the system, unless we are compelled to do so by a clear, positive command in the [applicable retirement law].” Id. at 352.

Under the TRL and case law, it is clear that the State has “guaranteed full payment” of the benefits promised, and has not limited its liability to the amounts administered from time to time by CalSTRS.

Section 22001 – the very first substantive provision in the TRL – expressly states that CalSTRS was established to “provide a financially sound plan for the retirement” of its members. Section 22955(d), which is a subdivision of a code section relating to State contributions to CalSTRS, also provides that “[p]ursuant to Section 22001 and case law, members are entitled to a financially sound retirement system. It is the intent of the Legislature that this section shall provide the retirement fund stable and full funding over the long term.” Finally, section 22214 expressly states that the board “may take any action it deems necessary to ensure the continued right of members or beneficiaries to receive monthly payments.” This conclusion is further supported by California Teachers Association v. Cory (1984) 155 Cal.App.3d 494, which explained the State’s obligation to CalSTRS members in these terms:
Given this commitment to permanency of funding and the critical importance which funding bears to the capacity of the state to fulfill the underlying contractual promise to pay the pensions, we imply a promise of funding in exchange for the valuable services rendered by the state’s teachers. The interest of the employee is in the security and integrity of the funds available to pay future benefits. This palpable element of exchange results in a contractual “promise”, i.e., an intent to confer private rights. Id. at 506 (emphasis added).

In sum, it is clear that the State will ultimately be responsible for finding a way to fully fund the benefits that it has promised to CalSTRS’ members and their beneficiaries.

The board has the authority and the fiduciary responsibility to demand that the State sufficiently fund the system to ensure a “financially sound retirement system...[with] stable and full funding over the long term.” Section 22955(d).

E. The Board’s Role

Under the California Constitution (Art. XVI sec. 17) and the California Education Code (sections 22202, 22250 et al.), the board has the exclusive plenary authority and fiduciary duty to administer the CalSTRS in a manner that will assure prompt delivery of benefits and related services to the members and beneficiaries of the system. Education Code section 22214 provides that the board “may take any action it deems necessary to ensure the continued right of members or beneficiaries to receive monthly payments,” and section 22207 provides that the board “shall perform any other acts necessary for the administration of the system.”

1. Key Guideposts. The following guideposts should assist the board and staff of CalSTRS as they consider the system’s funding challenges:

   - Are our actions designed to maintain the financial soundness of the retirement system?
   - Are our actions designed to assure the prompt delivery of benefits and related services?
   - Are others proposing any improper “impairment” of the vested rights of our members and their beneficiaries?
   - Are our actions designed to treat all members and beneficiaries in an impartial manner?
   - Do the actions of CalSTRS pose actual or perceived conflicts of interest for any board members or Staff?
   - Is any proposed action inconsistent with the board’s fiduciary duties?
   - Are we complying with applicable CalSTRS policies?
   - Are we ensuring that funds spent in any process relating to potential changes in funding or benefit structures are appropriate expenditures of trust or public funds?
In the most essential terms, the board is tasked with keeping the promises made by the State to the members of the system and their beneficiaries. The State has made these promises through the Legislature’s design of the retirement system (e.g., benefits provided, eligibility requirements, funding obligations). The board is charged with administering the system to fulfill the State’s promises. It is not charged with promoting changes in the design of the system, or in the balance of the sources of contributions to fund the system.

There is no explicit provision in law that obligates CalSTRS to develop and recommend a solution to its funding problems. This is different from some other systems, which operate under express legislative direction to promote funding solutions.

2. **Basic Issues**. CalSTRS’ actions should be premised on the board’s fiduciary duties to its members and in particular its duty to provide for actuarial services to ensure the competency of the system’s assets. These duties create the need for CalSTRS to engage in a diligent investigation of all facets of the funding risk that the system faces. This would include a complete analysis of:

   - What further work -- actuarial, financial, legal -- is required to fully evaluate the nature and scope of the risk to the system?
   - How should the board educate its members, retirees and beneficiaries about the risk?
   - How should the board educate the State, the school employers, and the general public about the risk?
   - If a solution is proposed or adopted by the Legislature, the Governor, the school employers, representative labor groups, members and/or the public, does it adequately mitigate the risk?
   - What extrinsic legal constraints must the board comply with in fulfilling its responsibilities?

3. **Guidelines**. Going forward, the board should observe the following guidelines:

   - Conduct open and public proceedings in accordance with the Bagley-Keene Open Meetings Act.
   - Publicly and prominently disclose the identity of those board members who are **ex officio** or CalSTRS members and the fact that they have been advised by counsel that they do not have a disqualifying conflict of interest in deliberating and voting on board actions related to the funding issues.
   - Establish and maintain throughout the process a complete record of deliberations and actions taken.
   - Regularly consult with its actuary regarding the long term funding outlook for the benefits that have been promised to CalSTRS’ members and their beneficiaries (with the actuary’s findings regularly publicized and shared with the employers, the State and the members).
The board should focus on determining (1) what constitutes a prudent long-term funding objective; and (2) what level of additional contributions – without regard to the source – would be required to meet that funding objective. It is not within its responsibilities for the board to develop and recommend a comprehensive solution to the current funding problem that identifies specific potential reductions to benefits or specific potential increases in contributions from specific sources. By focusing on the current system’s overall funding requirements, rather than proposing specific solutions, the board can adhere to its fiduciary duties and be a driver of the discussion of funding strategies.

4. Conflict of Interest Concerns

The Constitution, the TRL and case law all make clear that the CalSTRS Board and its employees are fiduciaries of the trust fund, with a paramount duty of loyalty to the members and beneficiaries of the system. The Legislature, however, designed the board to contain a balance of ex officio, appointed and elected members. See, section 22200. The elected members, by law, are required to be active members of the system at the time of their election. One appointee must be a retired member of the system and another must sit on a school board or the board of a community college district. The four ex officio members all have concurrent responsibilities to the State. Only three members are appointed from the general “public.”

In their board capacities, members of the board are also public officials, subject to the conflict of interest provisions of the Education Code and the Government Code and regulations promulgated thereunder. Those laws have as their primary purpose assuring that public officials perform their duties in an impartial manner, free from any bias caused by their own personal financial interests.

During the course of the board’s deliberations over meeting the system’s funding challenges, and during the course of time that CalSTRS engages with other State and local departments and agencies over these issues, concerns may arise as to the multiple interests and capacities of the Board’s members. There will be decisions and perhaps contracts to be entered into that may affect some board members personally, whether directly or indirectly, and this will naturally trigger concerns under the State’s conflict-of-interest laws. Possible increases in employer or employee contribution rates are good examples of decisions that may affect the personal financial interests of individual board members, indirectly through their employers or directly through their paychecks.

The basic conflict of interest laws include: (1) the Political Reform Act, Government Code sections 87100 et seq. (“Political Reform Act”), along with regulations promulgated under the Political Reform Act by the Fair Political Practices Commission (“FPPC”); (2) Government Code sections 1090, et seq., which governs conflicts of interests relating to contracts; and (3) Education Code section 22253. The board’s Policy Manual, at Part 600, mirrors certain of these provisions of state law.
The board should be guided by these general principles that arise from the State’s conflict of interest laws:

- Each board member should examine every matter that comes to the board’s agenda for the possibility that the matter could affect the personal financial interests of that member or his/her immediate family members.
- Generally speaking, there is usually no disqualifying conflict-of-interest if an agenda item affects only the State government as a whole, or affects the board member’s interests no differently than the interests of a great number of other CalSTRS’ members.
- Conversely, there usually is a disqualifying conflict-of-interest if an agenda item affects the board member’s employing department or agency or it affects the board member’s personal financial interests in some unique way not shared by many other members of the retirement system.
- Any time an agenda item appears to affect a board member’s employing department or agency, or unique personal financial interests, whether positively or negatively and however slight, the board member should publicly disclose that potential interest and consult with board counsel to determine if further action by the member or the board (e.g., recusal or board disqualification) is appropriate.

The same principles apply to CalSTRS’ staff members who participate in or influence the board’s deliberations and decision making, since they are also considered to be “public officials.” However, given that CalSTRS staff are not members of the Defined Benefit Program, the probability that any staff could benefit from any actions with respect to the program are very remote.

Each potential action must be analyzed on its own facts, and when possible, counsel and staff also should alert board members to potential financial interests that could trigger conflict of interest concerns. Board members should consult with the General Counsel or Privacy and Compliance Counsel if they have questions.

Once a financial interest is identified, board counsel should be consulted to determine whether disclosure and/or recusal are required under either the Political Reform Act or Government Code section 1090 (and in some cases whether the action is completely prohibited). All financial interests, no matter how remote, should be disclosed publicly and recorded in the minutes of the appropriate board meetings.
IV. CONCLUSION

CalSTRS' Board and staff can play an important educational and even catalytic role in assuring CalSTRS' near and long term success in delivering promised benefits to its members and their beneficiaries. All stakeholders - the State, school employers, members and the general public - need to understand the parameters of this legislatively designed benefit program and its funding challenges. This retirement system was founded as a trust, and continues to be viable only because of trust - trust that the government will keep its promise to those who have served the People's interests.

The board can and should actively engage all stakeholders in this process. We look forward to working closely with the Board to further to achieve its long-term goals.
APPENDIX

DIRECTORY OF LEADING CASES

Vested Rights Cases

*Kern v. Long Beach* (1947) 29 Cal.2d 848: In California, a pension promised to a public employee is not a gratuity that can be taken away. Rather, it is protected from impairment by the United States and California Constitutions.

*Miller v. State of California* (1977) 18 Cal.3d 808: “[T]he right to pension benefits vests upon the acceptance of employment, even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied.”

*Betts v. Board of Administration of Public Employees’ Retirement System* (1978) 21 Cal.3d 859: “An employees contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee’s subsequent tenure.” “The comparative analysis of disadvantages and compensating advantages must focus on the particular employee whose own vested pension rights are involved.”

*United Firefighters of Los Angeles City v. City of Los Angeles* (1989) 210 Cal.App.3d 1095: A law that capped annual cost of living increases was an unlawful impairment of contract for employees who worked before the cap was established.

*Pasadena Police Officers Association v. City of Pasadena* (1983) 147 Cal.App.3d 695: “[W]here the employee’s contribution rate is a fixed element of the pension system, the rate may not be increased unless the employee receives comparable new advantages for the increased contribution.”

*Association of Blue Collar Workers v. Wills* (1986) 187 Cal.App.3d 780: City unlawfully impaired employees contractual rights by amending its Municipal Code to require additional contributions from the employees to cover the unfunded liabilities of cost-of-living benefits, because the plan terms did not contemplate employees covering any part of the system’s UAAL. “The city cannot prevail on a theory of economic necessity or upon a theory that the integrity of the system would fail if it had to finance the entire debt related to past unfunded liability.”

*Sonoma County Organization of Public Employees v. County of Sonoma* (1979) 23 Cal.3d 296: Substantial budget shortfalls in the immediate aftermath of Proposition 13 were not a valid reason to limit cost-of-living increases promised to public employees.
Int'l Ass'n of Firefighters v. City of San Diego (1983) 34 Cal.3d 292: Member contribution rates may be changed based on changing actuarial assumptions, if the plan at issue contemplates such changes in member contributions. Also, this case articulates the test for lawful alteration of active members’ retirement rights: “[V]ested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Nonetheless, such modifications must be reasonable, and to be sustained as such, alterations of employees’ pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. Further, it is advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured.”


Claypool v. Wilson (1992) 4 Cal.App.4th 646: Like active employees, retirees and inactive members have a vested right to the benefits that were in place when they were employed. Retirees and inactive members do not, however, have vested rights to any beneficial changes in the law that apply to allowances after their employment, because a “member whose employment terminated before enactment of a statute offering additional benefits does not exchange services for the right to the benefits.” Note, however, that a retired or inactive member may obtain a vested right to a post-retirement improvement if he or she gave up another right acquired during service in exchange for the post-employment improvement.

“Considerations external to the functioning of [PERS] will not justify a change in the system. The justification must relate to considerations internal to the pension system, e.g., its preservation or protection or the advancement of the ability of the employer to meet its pension obligations...That is not to say that a purpose to save the employer money is a sufficient justification for change. The change must be otherwise lawful and must provide comparable advantages to the employees whose contract rights are modified.”

Allen v. Bd. of Admin. (1983) 34 Cal.3d 114: “Laws which restrict a party to those gains reasonably to be expected from the contract are not subject to attack under the Contract Clause, notwithstanding that they technically alter an obligation of a contract.”

Abbott v. City of Los Angeles (1958) 50 Cal.2d 438: “Rising costs alone will not excuse the city from meeting its contractual obligations, the consideration for which has already been received by it.” In attempting to change the city pension system from fluctuating to fixed pensions, the court must “measure advantages and disadvantages based on earned benefits of each employee,” “and benefits subsequently obtained by other employees cannot operate to offset detriments imposed on those whose pension rights have theretofore accrued.”
Medina v. Board of Retirement (2003) 112 Cal.App.4th 864: Members misclassified as “safety” not entitled to safety status, even though they relied upon years of representations from the retirement system as to their safety status. Government agency may not be estopped from reducing benefits where it never had the legal authority to grant them. The Contracts Clause only protects lawful contracts that are consistent with law and supported by consideration, and it does not protect “contracts” based solely on estoppel.

**Funding Obligation**

Bellus v. City of Eureka (1968) 69 Cal.2d 336: When retirement laws “can reasonably be construed to guarantee full payment to those entitled to its benefits regardless of the amount in the fund established by the pension plan, then we are, of course, required to construe the provision liberally in favor of the [pensioner] so as to carry out their beneficent policy ... It obviously would be unjust to make the payment of pensions dependent upon the solvency of a particular fund, thereby depriving employees of the benefits of the system, unless we are compelled to do so by a clear, positive command in the [applicable retirement law].”

California Teachers Association v. Cory (1984) 155 Cal.App.3d 494: “Given [the] commitment to permanency of funding and the critical importance which funding bears to the capacity of the state to fulfill the underlying contractual promise to pay the pensions, we imply a promise of funding in exchange for the valuable services rendered by the state’s teachers.”

Teachers Retirement Board v. Genest (2007) 154 Cal.App.4th 1012: CalSTRS members have a vested right to the statutorily required employer contributions to the retirement system – even if those contributions are not required for actuarial soundness.

Valdes v. Cory (1983) 139 Cal.App.3d 773: Ability to impair contracts in an “emergency” is very limited. It can only be done if: (1) the enactment must serve to protect “basic interests of society;” (2) there must be an “emergency justification for the enactment”; (3) the enactment must be “appropriate for the emergency;” and (4) the enactment must be “designed as a temporary measure, during which time the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment.” “It is apparent from the circumstances surrounding the enactment of chapter 115 that the goal of the emergency legislation is to resolve the state’s pending fiscal crisis, not to promote or protect the integrity of PERS or benefits to its members.”

Board of Administration v. Wilson (1997) 52 Cal.App.4th 1109: A “fiscal emergency” did not justify failing to pay required contributions to CalPERS. “A governmental entity can always find a use for extra money, especially when taxes do not have to be raised.”

Kaho’ohanohano v. State (2007) 114 Haw. 302: Regarding the state retirement system in Hawaii: “[C]harged with general administration and responsibility for the proper operation of the retirement system, and the protection of the res, Trustees have a legal duty to protect the pension accumulation fund from diminishment and impairment, for the viability of the retirement system itself.
Conflicts of Interest

Lexin v. Superior Court (2010) 47 Cal.4th 1050: “If the financial interest arises in the context of the affected official’s or employee’s role as a constituent of his or her public agency and recipient of its services, there is no conflict so long as the services are broadly available to all others similarly situated, rather than narrowly tailored to specially favor any official or group of officials, and are provided on substantially the same terms as for any other constituent.” Also, disclosure and recusal is necessary when a contract directly involves the official’s “department,” but, only disclosure is necessary when the contract is with the larger employing governmental entity.

Board’s Paramount Fiduciary Duty To Members

City of Sacramento v. Public Employees Retirement System (1991) 229 Cal.App.3d 1470: “[A] trustee’s primary duty of loyalty is to the beneficiaries of the trust. The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary. The trustee must not be guided by the interest of any third person. This unwavering duty of complete loyalty to the beneficiary of the trust must be to the exclusion of the interest of all other parties. Under the rule against divided loyalties, a fiduciary cannot contend that although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one.”