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ATTORNEY-CLIENT PRIVILEGED COMMUNICATION

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Re: Application of AB 197 and AB 340 to the Merced County Employees Retirement Association

Dear Maria and Michael:

You asked that we advise the Merced County Employees Retirement Association ("MCERA") on the questions presented below regarding applicability to MCERA of (1) the California Public Employees' Pension Reform Act of 2013 ("PEPRA"), which was enacted as a result of Assembly Bill 340 ("AB 340"), and (2) Assembly Bill 197 ("AB 197"), which was signed subsequent to PEPRA. Both PEPRA and AB 197 already have been chaptered and take full effect on January 1, 2013.

PEPRA creates a new Article 4 in California Government Code sections 7522-7522.72.[1] The majority of the changes to be instituted as a result of PEPRA apply to "new members" as defined therein and discussed below.

AB 197, on the other hand, amends the current definition of "compensation earnable" in section 31461 by adding a new subdivision (b), which lists certain pay items that must, or may, be excluded from "compensation earnable" by systems governed by the County Employees' Retirement Law of 1937 ("CERL"). AB 197 is applicable to all individuals who retire from MCERA on and after January 1, 2013, to the extent their retirement allowance calculation is not subject to PEPRA rules governing "new members." AB 197 also adds a new subdivision (c) to section 31461, which

[1] All statutory references are to the California Government Code unless otherwise stated.

states that 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 ("*Salus*") and *In re Retirement Cases* (2003) 110 Cal. App. 4th 426 ("*In re Retirement Cases*")."

Questions Presented

1. Treatment of Leave Cash-Outs in Retirement Allowance Calculations on and after January 1, 2013

a. In light of the new language of sections 31461 and 7522.34, shall MCERA, after January 1, 2013, continue to pay retirement allowances that include components of compensation earnable for: (i) the 160 hours of terminal leave time pay-outs that are currently included as required by MCERA's *Ventura* settlement agreement[2]; and (ii) non-terminal cash-outs that occur during the final compensation period[3], which are now mandatorily included in compensation earnable, in addition to the terminal cash-outs, as required by the Merced County Superior Court's 2007 decision *Baker* decision?

b. To the extent that either or both types of payments are still to be included in compensation earnable, are they subject to any new limits by AB 340 and/or AB 197?

c. To what extent, if at all, do these answers vary between new members (as defined by AB 340) and others?

d. Should MCERA and Merced County ("County") attempt to modify the *Ventura* settlement agreement to comply with the new statutory provisions?

2. Who is within, and who is not included in, the definition of "new member" at PEPRA section 7522.04(f), with particular focus on the situations that will (or will not) permit an MCERA member to avoid "new member" status under section 7522.04(f)(3) (the "six-month break in service" provision)?

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[2] By settlement agreement dated June 14, 2000, MCERA resolved a class action that had been filed against it in Merced County Superior Court Case No. 138795 that arose as a result of the Supreme Court's decision in *Ventura County Deputy Sheriff's Assoc., et al. v. Board of Retirement of Ventura County, et al.* (1997) 16 Cal. 4th 483 ("*Ventura*"). That agreement is commonly referred to as the "*Ventura* settlement agreement". MCERA's *Ventura* settlement agreement was approved by a Judgment rendered on August 11, 2000 in Judicial Council Coordination Proceeding No. 4049, in San Francisco Superior Court ("JCCP"). The JCCP resulted on appeal in the published decision, *In re Retirement Cases*.

[3] MCERA refers to these in-service cash-outs as the "25th pay period".

Summary of Conclusions

1. For the reasons discussed in the analysis below, we believe the following:

   - As of January 1, 2013, section 31461 will require MCERA to exclude from retirement allowances of members who retire on and after that date all terminal leave pay-outs for individuals, if their 25th pay period check already has been paid at the maximum permitted level.[4] MCERA must exclude these additional terminal pay amounts from retirement allowance calculations unless and until an appellate court instructs it not to do so on constitutional or other grounds.

   - Section 31461 continues to permit the 25th pay period check to be included in retirement allowance calculations for individuals who are not "new members" under PEPRA, because it reflects the amount that is both "earned" and "payable" annually during the final compensation periods of all current active and deferred MCERA members.

   - With respect to "new members" under PEPRA, section 7522.34 prohibits the inclusion of both leave sell-backs during employment (the 25th pay period check), and all leave pay-outs at termination (the 160 hour pay-out) in the calculation of retirement allowances.

   - There may be value in attempting to modify the *Ventura* settlement agreement as to individuals who will not be deemed "new members" under PEPRA, if the County and impacted MCERA members are willing to do so.

2. Regarding the definition of "new members" under PEPRA, we believe the following:

   - "New member" does <u>not</u> include MCERA's current active, deferred or retired members, or those who join MCERA in the future and are eligible for reciprocity with other public retirement systems that they joined prior to January 1, 2013, except to the extent that the following proviso applies.

   - Any current MCERA active member who separates from employment and defers retirement or retires, and any current deferred or retired member, who then returns to active service more than six months after leaving employment with an MCERA plan

[4] If the member's 25th pay period check was for less than the maximum permitted level, then only the remaining permitted amount that was both earnable and payable in that 25th pay period check, but that was not paid in that check, can be included in the retirement calculations from the terminal leave pay-out.

sponsor and works for a *different* plan sponsor within MCERA (e.g., County to Cemetery District) on or after January 1, 2013, even if the individual retained his or her contributions on deposit or redeposited them, would likely be considered a "new member" under section 7522.04, subdiv. (f), for that post-January 1, 2013 period of service.

Brief Background

The responses to the questions presented above require consideration of the following facts, some of which are unique to MCERA.

First, MCERA's *Ventura* settlement agreement, which, as noted in footnote 2 above, was approved by Court Judgment, provides in pertinent part as to members retiring in and after October 1997, that MCERA would include within compensation earnable the vacation and other leave accrued in their final compensation period, up to "a maximum of 160 hours of annual leave, a maximum of one-year's leave accrual, or the number of annual leave hours actually included in the Member's vacation pay-off, whichever is less."

Second, in October 2006, the MCERA Board sought a judicial interpretation of the June 2000 *Ventura* settlement agreement regarding whether it was permissible to include vacation sell-back (the 25th pay period check) when calculating the 160 hour cap on annual leave that must be included in retirement allowance calculations under that agreement. On September 21, 2007, the Merced County Superior Court issued a decision concluding that *Ventura* requires all annual vacation sell back that an employee is authorized to cash out during the employee's final compensation period, and that is cashed out during the final compensation period, to be included in retirement allowance calculations (the "*Baker* decision"). The Court also analyzed the later 2004 *Salus* decision and concluded that that opinion did not change the Court's conclusion about its understanding of the *Ventura* decision, and of the parties' intentions at the time the settlement agreement was made, that the 25th pay period check was neither subject to the 160 hour limit in the *Ventura* settlement agreement, nor could it reduce the inclusion of up to 160 hours of accrued leave pay-out at retirement provided by the settlement agreement. *Baker* decision, 5:11-14 ("The circumstances that existed at the time of the Settlement Agreement favor a finding that the 160 hour limitation applies only to 'vacation payoff,' in other words vacation paid on the date of retirement and does not to apply 'annual vacation sell back,' that is accrued vacation cashed out during the final compensation period at the time prior to the date of retirement."). The *Baker* decision was not appealed and is final and binding on MCERA.

Since the *Baker* decision, MCERA has continued to include all annual leave sell-backs that are made during the final compensation period (the 25th pay period) in retirement allowance calculations, as well as the leave pay-out on termination up to a maximum of 160 hours.

Third, MCERA's *Ventura* settlement agreement was certified as to a class of all "Members," who were defined therein as "All active Members, Retired Members, Deferred Members and Future Members of [MCERA], as those terms are defined herein." Thus, not only does it cover all current MCERA members, but it purports also to set forth the rights of *future* MCERA members. Further, the parties to the settlement agreement acknowledged the risk of inconsistent future court rulings and indicated their agreement and intention to be bound by the terms of the agreement regardless of any such judicial decisions or rulings. There is no provision specifically dealing with future inconsistent legislation, however, although there is a severability clause if any provision of the agreement were held to be invalid.

Legal Analysis

1. Pensionability of Leave Cash-Outs on and after January 1, 2013

A. Rules Applicable to MCERA's Current Active, Deferred, Redepositing and Non-PEPRA Reciprocal Members

Section 31461's new definition of "compensation earnable" as set forth in AB 197 applies to all MCERA members who retire on and after January 1, 2013, unless those MCERA members are "New Members" under PEPRA, in which case section 7522.34's definition of "pensionable compensation" applies.[5]

New subdivision (b) of section 31461 provides, in pertinent part, as follows:

> 'Compensation earnable' does not include, in any case, the following:
>
> . . .
>
> (2) Payments of 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

[5] As discussed in response to question no. 2 below, in the future, there will be MCERA members who earn both pre-PEPRA and PEPRA service credit. Thus, the rules described in this response will apply to their pre-PEPRA service, while the rules described as to "new members" under PEPRA below will apply to their post-PEPRA service.

> 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.[6]

Significantly, the new language of section 31461 requires that leave sell-back have been "earned" as well as "payable" *during* the final compensation period in order to be included in "compensation earnable." This is important because the compensation earnable definition as of January 1, 2013 will now *exclude* from compensation earnable those leave cash-outs that are *not* payable during employment, but only on separation from employment. This new provision is "consistent with" *In re Retirement Cases*, as the court in that case held that "if [members] do not or cannot cashout their [vacation or sick leave] time prior to retiring, they have received an 'in-kind' benefit, not to be calculated as part of their final compensation." *Id.* at 475. Thus, the court there held with regard to the statute then in effect 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 new statute is also "consistent with" *Salus*, which disallowed the inclusion of accrued leave paid out at retirement that could not have been cashed out during employment.

All County employees other than its Chief Executive Officer ("CEO") earn a maximum of 160 hours in vacation leave and 96 hours of sick leave annually, for a total vacation and sick leave accrual of 256 hours annually. Certain County employees may sellback vacation leave up to 80, 40 or 20 hours annually, depending on their management level, plus a maximum sick leave sell-back of 40 or 50 hours, depending upon bargaining group. The CEO is permitted by his employment agreement with the County to earn *and* sellback 320 hours of accrued leave annually.

Thus, the maximum leave sell-backs permitted for all County employees, including the CEO, not exceed the amount that they may earn annually.

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[6] Of note, AB 340 also includes a new definition of "compensation earnable," which requires only that unused leave be "earned" in a 12-month period during the final average salary period, but not necessarily "payable" during employment. In response to criticism of that provision, the Legislature adopted AB 197, and the Governor signed AB 197 after AB 340, such that the addition to section 31461's definition of compensation earnable in AB 197 supersedes the definition included in AB 340.

Section 31461 therefore continues to permit the 25th pay period check to be included in retirement allowance calculations as to service rendered as a non-New PEPRA Member, because it reflects the amount that is both "earned" and "payable" annually during the final compensation periods of all County employees.[7]

The 160 hours of vacation pay-out provided by the *Ventura* settlement agreement, and as permitted to continue to be paid under the *Baker* decision without reduction by the amount of the annual vacation sell-back, on the other hand, appears to violate the new statutory prohibition in section 31461 on the inclusion in termination pay because, by definition, its payment exceeds amounts earned and payable during employment (that is, an amount equal to all possible "earned and payable" amounts during the final compensation period are already included in the 25th pay period check permitted only on an annual basis).

The California Constitution, article 3, section 3.5, provides, in pertinent part, that an administrative agency, such as MCERA, "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." *Valdes v. Cory* (1983) 139 Cal. App. 3d 773 (state controller, the public employees' retirement system board of administration and school employers of school-employee petitioners had constitutional duty to comply with challenged provisions of legislation unless and until an appellate court declared those provisions unconstitutional).

Here, Section 31461, subdivisions (b)(2) and (4) would be unconstitutional either on their face, or as applied, if they deprived current members of rights protected by the California Constitution. Even if they are unconstitutional, however, MCERA does not have the authority to declare their unconstitutionality and refuse to enforce the statute.

Accordingly, as of January 1, 2013, MCERA will be required by AB 197 to exclude terminal leave pay-outs from retirement allowances commencing thereafter for individuals if their 25th pay period check already has been paid at the maximum permitted level and included during their final compensation period even though the Ventura settlement agreement, as interpreted in the Baker decision, provides that terminal leave pay-outs are to be included up to 160 hours regardless of the amount paid and included in the 25th pay period check. If the member's 25th pay period check is for less than the maximum permitted level then only the remaining permitted amount that was both earnable and payable in that 25th pay period check but that was not paid in that check can be included in the retirement calculations from the member's terminal leave pay-out.

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[7] We understand that the Merced Superior Courts have comparable provisions regarding earned and cashable accrued leave to the County's. Other employer plan sponsors of MCERA do not currently permit any leave to be cashed out prior to retirement, and thus they do not pay a 25th pay period check.

B & C. Rules Applicable to "New Members" Under PEPRA

Section 7522.34 of PEPRA provides that "pensionable compensation" of a new member (as defined) of any public retirement system *does not include*:

> (5) Payments for unused vacation, annual leave, personal leave, sick leave, or compensatory time off, however denominated, whether paid in a lump sum or otherwise, regardless of when reported or paid.

Thus, PEPRA prohibits the inclusion of both leave sell-backs during employment, and leave pay-outs at termination, in the calculation of retirement allowances for "new members" as defined therein.

D. Should MCERA and the County Attempt to Modify the Ventura Settlement Agreement to Comply with the New Statutory Provisions?

With respect to current and deferred members, AB 197's new prohibition on including in compensation earnable the terminal pay that is not "earned and payable" during the final compensation period (that is, prior to termination) deprives members of the benefit for which they bargained in the *Ventura* settlement agreement. Accordingly, to the extent that the County is willing to negotiate with members to provide a comparable new advantage that is permitted by existing law, in exchange for no longer including any terminal pay in retirement allowance calculations and modifying the *Ventura* settlement agreement to that effect, that approach may warrant consideration, given the litigation we expect will ensue in the absence of such a compromise. Any modified settlement agreement would likely, however, require further judicial approval, with appropriate notice to the affected classes.

With respect to New PEPRA Members, on the other hand, we believe a court would likely *permit* the legislative change in the definition of "pensionable compensation" notwithstanding the *Ventura* settlement agreement because it applies only to those who have never had rights in the MCERA retirement plan or have withdrawn their contributions and failed to redeposit such that they have no rights in the prior plan. *See Legislature v. Eu* (1991) 54 Cal.3d 492, 534 ("As for incumbent legislators first assuming office after Proposition 140 became effective, it seems clear that they acquired no vested or protectable right to a continuation of the pension system in operation prior to their employment and, accordingly, the measure properly may be applied to them"). Thus, we believe that MCERA (and the County) can, and should, take the position that AB 340, as it applies to New PEPRA Members, simply supersedes the *Ventura* settlement agreement, which explicitly protected future members from adverse judicial rulings, not legislative changes.

2. *Definition of "New Member" Under PEPRA*

PEPRA defines "new member" as follows:

> (1) An individual who becomes a member of a public retirement system for the first time on or after January 1, 2013, and who was not a member of any other public retirement system prior to that date.
>
> (2) An individual who becomes a member of a public retirement system for the first time on or after January 1, 2013, and who was a member of another public retirement system prior to that date, but who was not subject to reciprocity under subdivision (c) of Section 7522.02.
>
> (3) An individual who was an active member in a retirement system and who, after a break in service of more than six months, returned to active membership in that system with a new employer. For purposes of this subdivision, a change in employment between state entities or from one school employer to another shall not be considered as service with a new employer.

Section 7522.04, subdiv. (f) ("New PEPRA Member").

MCERA's current *active* members are therefore not New PEPRA Members, because they are currently members of "a public retirement system," as defined in PEPRA, and thus are not becoming a member of a public retirement system "for the first time" on or after January 1, 2013.[8]

MCERA's *deferred* and future *returning deferred* members who return to the *same employer* within MCERA also are not New PEPRA Members, because, under the CERL, they never had a "break in service" in that they retained their contributions on deposit with MCERA when they were not in active membership and have not returned to a "new employer" in MCERA under paragraph 3

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[8] PEPRA defines a "public retirement system" as including "any pension or retirement system of a public employer. ..." Section 7522.04, subdiv. (j). PEPRA defines a "public employer" very broadly to include, among others, "(1) the state and every state entity, including, but not limited to, the Legislature, the judicial branch . . . and the California State University. (2) Any political subdivision of the state, or agency or instrumentality of the state or subdivision of the state, including, but not limited to, a city, county, city and county, a charter city, a charter county, school district, community college district, joint powers authority, joint powers agency, and any public agency, authority, board, commission, or district. (3) Any charter school that elected or is required to participate in a public retirement system."

of subdivision (f) quoted above. Section 31642 ("The following shall not be considered as breaking the continuity of service: . . . (d) [deferred retirement]"); *see also San Diego County Employees Ass'n. v. County of San Diego, et al.* (2007) 151 Cal. App. 4th 1163; 2007 Cal. App. LEXIS 947, p. 8 (describes Section 31642 as providing five situations that "shall not be considered as breaking the continuity of service" including "Returning Deferreds, i.e., those who elected to leave their retirement contributions in the county when they terminated their county employment, and then were subsequently reemployed") ("*SDCERA v. County*").

Former MCERA members who *redeposit* their withdrawn contributions, with interest, with MCERA prior to retiring and return to the *same employer*, also should not be deemed New PEPRA Members because, also under Section 31642, their withdrawal and redeposit rendered their service "as if unbroken" and have not returned to a "new employer" in MCERA under paragraph 3 of subdivision (f) quoted above. *Id.; see also Aquilino v. Marin County Employees' Retirement Ass'n.* (1998) 60 Cal. App. 4th 1509 ("once a returning employee completes the redeposit of withdrawn retirement contributions, the employee resumes the *same membership status* [i.e., same membership tier] as if the employee had never left county employment") ("*Aquilino*").

In addition, individuals who first join MCERA on or after January 1, 2013, but who are subject to *reciprocity* as provided by Section 7522.02, subdivision (c), are not New PEPRA Members. That "reciprocity" provision of PEPRA states, in pertinent part:

> Individuals who were employed by any public employer before January 1, 2013, and who became employed by a subsequent public employer for the first time on or after January 1, 2013, shall be subject to the retirement plan that would have been available to employees of the subsequent employer who were first employed by the subsequent employer on or before December 31, 2012, if the individual was subject to reciprocity established under any of the following provisions:
>
> (1) [Public Employees Retirement Law applicable to CalPERS]
> (2) [the CERL]
> (3) Any agreement between public retirement systems to provide reciprocity to members of the systems.

On the other hand, under paragraph 2 of the "new member" definition in Section 7522.04, subdiv. (f), any individual who first joins MCERA membership on or after January 1, 2013, without pre-January 1, 2013, reciprocity with another public retirement system is a New PEPRA Member.

In addition, under paragraph 3 of subdivision (f), an individual who rejoins MCERA active membership but had a "break in service of more than six months," and returned to active membership in that system with a "new employer" would be a New PEPRA Member. This provision, which you identify in the second question presented, is, in our view, the most ambiguous of the three definitions of New PEPRA Member because of its use of the term "break in service." However, it also is quite specific as to whom it applies, and by implication does not apply, with respect to *different employers within the same retirement system.* Although not without doubt, we believe the provision means that an individual who left employment with one CERL plan sponsor and returned to employment with a *different* employer in the *same* retirement system *more than six months later* has a "break in service of more than six months," that would render his or her *post-*January 1, 2013, period of service subject to the rules applicable to New PEPRA Members, even if he or she left his or her member contributions on deposit with the retirement system or had withdrawn and then redeposited them.

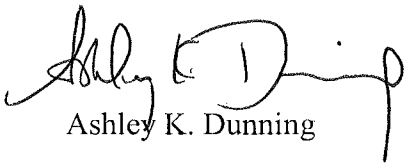
If, however, that individual were to return to MCERA to work for a different employer in MCERA *within* six months, that individual would be entitled to the plan in effect as to that position on December 31, 2012, as applies to reciprocal members who join MCERA under PEPRA. In addition, as noted above, if the member is rehired by the *same* employer, even if more than six months later, that member would not be deemed a New Member subject to PEPRA, but rather would return to his or her original tier in MCERA and with that plan sponsor, in accordance with *Aquilino.*

Finally, even though an individual may be deemed a New PEPRA Member with respect to service that he or she accrues at MCERA on and after January 1, 2013, under the circumstances described above, it is possible that such an individual may also previously have earned a retirement benefit from another public employer (including a different MCERA plan sponsor) that would still be determined under the pre-PEPRA rules.

This letter is intended for the Merced County Employees' Retirement Association only and should not be relied upon by anyone else.

I will be happy to respond to questions regarding the foregoing.

Sincerely,



Ashley K. Dunning