

TO: Members of the MCERA Board
Maria Arevalo, MCERA Administrator

FROM: Michael P. Calabrese, Chief Deputy County Counsel

DATE: October 10, 2012

RE: Assembly Bills 340 and 197

INTRODUCTION

Assembly Bills 197 and 340 recently completed their journey through the legislative process and have become law in California. The bills make sweeping changes to the County Employees' Retirement Law of 1937 (the "CERL") and related provisions of the Government Code, principally in the area of determining final compensation.

AB 340 adds numerous sections to the Government Code, including a new Article 3 of Title 1, Division 7, Chapter 21. This new Article 3, officially the "Public Employees' Pension Reform Act of 2013," has come to be colloquially known as "PEPRA." Cal. Gov. Code § 7522. PEPRA does not directly amend the CERL, but it changes the operation of the many of the CERL's provisions, in some cases amending them by implication. AB 340 also contains explicit amendments to several CERL sections. With some limited exceptions, AB 340's provisions only apply to "new members" who join a public retirement system like MCERA on or after the bill's January 1, 2013 effective date.

AB 197 amends section 31461 of the CERL, which defines "compensation earnable." AB 197 changes the existing definition mainly by listing numerous exclusions. This has the effect of limiting the kinds of pay that may be included in a member's final compensation, which is a key element in determining the member's monthly pension upon retirement. Very significantly, AB 197's provisions, by their terms, apply to members who are currently employed by CERL system sponsor employers. Thus, it has real and significant potential to adversely affect the pensions received by current Merced County employees who retire on or after January 1, 2013.

MCERA has recently secured an opinion from Ashley Dunning, outside counsel with Mannat, Phelps and Phillips, addressing issues arising from the bills' provisions regarding the exclusion of certain leave cash-outs from the definitions of "pensionable compensation" (AB 340) and "compensation earnable" (AB 197), as well as AB 340's definition of "new member." Ms. Dunning's memo has been provided to the MCERA Board separately.

This memo will address numerous other questions arising from the bills' untested and often ambiguous provisions.

QUESTIONS

- 1) Will current MCERA retirees, or those who retire before the end of 2012, and who wish to return to work on or after January 1, 2013 be forced to wait at least 180 days before they may return to work while still collecting their pensions? Does this provision apply differently to safety members and miscellaneous members?

- 2) After January 1, 2013, may an employee who has, prior to that date, been promoted to a position eligible for Tier 1 benefits, and who was previously in Tier 2, convert the Tier 2 service to Tier 1 by paying the actuarial cost of the difference between the two benefit structures for the time to be converted?
- 3) May an employee who, after January 1, 2013, is promoted from a position with non-Tier 1 benefits to a position that is currently eligible for Tier 1 benefits switch to Tier 1 for the future service rendered in the higher position?
- 4) What process should MCERA implement, effective on and after January 1, 2013, to determine what items of compensation are eligible for inclusion in “compensation earnable” and “final compensation?”
- 5) Will employer contributions henceforth be limited by the fact that pension contributions for new members will be limited to the federal social security cap for employees who participate in social security, and to 120% of the cap for employees who do not?
- 6) Is the requirement that “new member” employees contribute 50% of actuarial cost of their pension limited to 50% of the “normal cost of the benefit level?”

DISCUSSION

- 1) Will current MCERA retirees, or those who retire before the end of 2012, and who wish to return to work on or after January 1, 2013 be forced to wait at least 180 days before they may return to work while still collecting their pensions? Does this provision apply differently to safety members and miscellaneous members?

Section 7522.56 addresses the new limitations on the return to work of a retired member. By its terms, that section is applicable to “*any person* who is receiving a pension from a public retirement system,” and supersedes any other statute on the subject that may be in conflict, such as sections 31680 et seq of the CERL. Under section 7522.56, a retired person may not return to work without “reinstatement from retirement” (i.e. a suspension of the payment of benefits) unless certain conditions are met. First, there must be either an “emergency” requiring the person’s service “to prevent stoppage of public business” or a situation where “the retired person has skills needed to perform work of limited duration.” Second, the work must be limited to no more than 960 hours in the fiscal year. Third, the pay must “not be less than the minimum, nor exceed the maximum” for others performing “comparable duties.” Fourth, if the person is not reinstated from retirement, they may not receive service credit. Fifth, the person is entirely ineligible for such work if they have received unemployment compensation arising from service to the same employer during the preceding twelve months, and the employee must certify in writing that they have not received such compensation. Sixth, with an exception as to “public safety officer and firefighters” (i.e. some but not all safety members), if the reemployment is to occur during the first 180 days after retirement, the employer must certify by legislative action, which may not be placed on a consent calendar, that “the appointment is necessary to fill a critically needed position.” Seventh, if the person accepted any retirement incentive, they are absolutely banned from any reinstatement for 180 days, and the “critically needed position” exception does not apply.

- 2) After January 1, 2013, may an employee who has, prior to that date, been promoted to a position eligible for Tier 1 benefits, who was previously in Tier 2, convert the prior Tier 2 service to Tier 1 by paying the actuarial cost of the difference between the two benefit structures for the time to be converted?

No. Section 7522.44(b) addresses this situation directly. It provides that if “a change in employment status results in an enhancement in the retirement formula or retirement benefit applicable to that employee, that enhancement shall apply only to service performed on or after the operative date of the change and shall not be applied to any service performed prior to the operative date of the change.” This section is explicitly made applicable to “all public employers and all public employees,” and thus is not limited to “new members” as are many of PEPRA’s provisions. The ban on converting past service is stated with no exception for conversion for which the employee pays. Thus, there can be no doubt that “tier conversion” for past service for a promoted employee has been prohibited, and will be unlawful on and after January 1, 2013. While the statute does not directly address the situation of an employee whose employment status changed before January 1, 2013, but proposes to convert the prior service after that date, the statute clearly states that any conversion “shall not be applied to any service performed prior to the operative date of the change” in employment status. The more likely interpretation is that if the conversion takes place after PEPRA becomes law, the PEPRA limit will apply to the conversion. Had the Legislature intended to create a savings provision for employees whose employment status changed before January 1, 2013, it would have done so explicitly.

- 3) May an employee who, after January 1, 2013, is promoted from a position with non-Tier 1 benefits to a position that is currently eligible for Tier 1 benefits switch to Tier 1 for the future service rendered in the higher position?

Yes, but only employees who are not “new members,” and only as to future service. As discussed above, section 7522.44 clearly contemplates that such changes may occur, and that such a “change in employment” may result in an employee’s becoming eligible for a higher tier. It does not ban this practice outright, but limits it as described in the prior paragraph.

- 4) What process should MCERA implement, effective on and after January 1, 2013, to determine what items of compensation are eligible for inclusion in “compensation earnable” and “final compensation?”

New section 31542(a) of the CERL (enacted in the non-PEPRA portion of AB 340) requires the Board of Retirement to “establish a procedure for assessing and determining whether an element of compensation was paid to enhance a member’s retirement benefit.” Thus, the Board has a new legal obligation to assess proposed elements of final compensation to determine specifically whether they fall outside of the permissible elements of “pensionable compensation” in section 7522.34 of PEPRA (as to new members) or new subsection 31461(b) of the CERL (as to legacy members). In either provision, there is an obligation to exclude from the pension calculation any element of compensation that the Board believes has been “paid to increase [the CERL term is “enhance”] a member’s retirement benefit.”

There is no affirmative obligation for the Board to establish a “procedure for assessing and determining” whether potential elements of final compensation meet the applicable definition in respects other than whether they are “paid to increase/enhance a member’s retirement benefit.” In the PEPRA context, that limitation is just one of twelve listed exclusions from “pensionable compensation” appearing in section 7522.34(c). This would seem to imply that there is no obligation for the Board itself to determine whether an item falls within the other eleven listed exclusions, all of which are more specific. In the CERL context, by contrast, the exclusion of items “paid to enhance a member’s retirement benefit” appears as a general exclusion at section 31461(b)(1), and is then followed by three specific examples of items that “may” be captured within the general exclusion, listed in subparagraphs 31461(b)(1)(A)-(C). These include payments for items that had previously been provided in-kind, “one-time or ad hoc” payments not provided to all similarly situated members, and termination pay-outs that exceed stated limits. Thus, there would appear to be an obligation for the Board itself to proactively determine whether an item violates these three specific limitations, as well as the general limitation.

Section 31542 is not specific as to the type of procedure that must be used to make these determinations. While other, larger CERL systems are apparently considering using a hearing officer process to provide initial recommendations for Board approval, such an approach is not mandatory and would likely be prohibitively expensive for a system of MCERA’s size. A more appropriate approach would seem to involve the Board making a determination, as a general policy matter codified in MCERA’s by-laws, that specific elements of compensation listed in the County’s Salary Allocation Resolution are presumptively either includable or excludable from pension calculations.¹ Staff would then be able to review each element of final compensation reported by the County for each retiring member, make an initial determination on their includability in accord with the codified Board policy implementing sections 7522.34 and 31461, and produce a brief report listing those elements, along with a recommendation for Board approval of each member’s retirement application consistent with the staff report. The member must then be given a chance to “present evidence” challenging any Board decision to exclude an item, per subsection 31452(a). Thus, any Board decision excluding any item of compensation should be provided to the member with an explanation, and with notice to the member that they may present evidence in support of a reversal of the Board’s initial decision. Such a procedure would likely be seen as a mandatory administrative process, and a prerequisite to the member’s challenging the exclusion by writ of mandate, which is a right provided in subsection 31452(b).

This is just one possible means of implementing the section 31542 requirement. As noted, because the statute does not mandate a particular procedure, but only that some procedure be established and include an opportunity for the member to challenge an adverse decision, there is flexibility here to create a procedure that best fits the particulars of MCERA’s size, membership, staffing, and budget constraints.

- 5) Will employer contributions henceforth be limited by the fact that pension contributions for new members will be limited to the federal social security cap for

¹ Counsel is presently in the process of reviewing the Salary Allocation Resolution and developing recommendations as to each element listed therein.

employees who participate in social security, and to 120% of the cap for employees who do not?

For new members, section 7522.10(c) limits pensionable compensation to either the federal cap on social security specified in section 430(b) of the federal Internal Revenue Code or, for non-participants in social security, one hundred twenty percent of that limit. Member contributions therefore will only be taken from employees' pay up to the applicable limit. You have asked whether employer contributions are also limited in this manner.

Because employer contributions are not determined as a percentage of individuals' pay, but rather as a percentage of total payroll in order to meet total system obligations, it would not be accurate to say that employer contributions are directly limited by the operation of section 7522.10(c). And indeed, no such limitation appears in the new laws. However, the section 7522.10(c) limit will have the effect of limiting employer contributions to some extent, since the total system obligations will be lower due to the operation of this provision, which will factor into the actuarial calculations that drive employer contributions. Employer contributions, however, are normally expressed as a percentage of total payroll. Because of section 7522.10(c), it appears that variations in payroll involving individuals' compensation in excess of the applicable caps should not result in any change in the normal cost of the benefit plan. Thus, we believe it would be proper to express employer contribution rates as a percentage of only that payroll that, for new employees, is within the applicable caps.

Because this view is derived in large part from our understanding of the actuarial process, and there is no explicit statutory instruction on this question, I have inquired as to whether MCERA's actuary concurs in this view, and have confirmed that he does.

- 6) Is the requirement that "new member" employees contribute 50% of actuarial cost of their pension limited to 50% of the "normal cost of the benefit level?"

Yes. Section 7522.30(b) makes clear that the new "50% requirement" is a requirement that the employee contribute at least 50% of "the annual actuarially determined *normal cost for the defined benefit plan* of an employer expressed as a percentage of payroll." (Emphasis supplied.) As you know, the concept of a "normal contribution rate" is defined by the CERL, and includes only that which is "sufficient to provide for the payment of all prospective benefits" to the member. Cal. Gov. Code § 31453.5. Thus, other items, such as a system's unfunded accrued liability, are excluded. The Legislature's choice to use the word "normal" in section 7522.30(b) appears to have been a conscious decision to limit the requirement as described.

CONCLUSION

Clearly, AB 197 and AB 340 will have very significant operational implications for MCERA. In addition, the bills' various provisions will have significant financial implications for members considering retirement, which will need to be communicated to MCERA's active membership with all deliberate speed. We stand ready to clarify any of the explanations set forth here, and to assist as appropriate with implementation tasks and member communication.