Fifth DCA Affirms Trial Court Ruling in Favor of County Retirement System and Rejects Fiduciary Breach Allegations

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On November 8, 2021, a decade-plus court battle concerning whether a public pension system and its board of retirement violated their fiduciary duties when making certain actuarial and reserving decisions following the Great Recession appears to have ended. The Fifth District Court of Appeal ("DCA") affirmed the decision of the Stanislaus County Superior Court in favor of defendants Stanislaus County Employees' Retirement Association ("StanCERA") and the County of Stanislaus ("County") in *O'Neal v. Stanislaus County Employees' Retirement Association, et al.* (Case No. F079201) ("*O'Neal III").*

O'Neal III is the third decision of the Fifth DCA in this litigation. Prior appellate decisions, one of which is published, had overturned trial court rulings after demurrer and after cross summary judgment motions. This third decision is unpublished and thus not citable as legal precedent. However, the 50-page opinion nevertheless provides some important guidance for fiduciaries.

In sum, *O'Neal III* affirmed the trial court's determination, after a two-week bench (non-jury) trial, that the StanCERA Board had not violated its fiduciary duties of loyalty and prudence in the late 2000s. During that time, the Board made five separate actuarial and reserving decisions in response to the substantial investment losses to StanCERA resulting from the Great Recession and related financial hardships to the County that threatened material layoffs of its employees. The "five challenged decisions" resulted in depleting a nonvaluation reserve that StanCERA previously had established for the provision of non-vested benefits to retirees.

While most of the *O'Neal III* decision focuses on and rejects plaintiffs' claims of procedural errors by the trial court, several points reflected in the opinion are of note for trustees of public pension funds and those who advise them.

First, the Court unreservedly affirmed and relied upon its prior published opinion in *O'Neal v. StanCERA* (2017) 8 Cal.App.5th 1184 ("*O'Neal II*"). This included the Court's conclusion that the Board's consideration of the County's potential for layoffs resulting from material and immediate increases in its retirement contributions provided a reasonable basis for taking the five challenged decisions. Each of these decisions lessened the immediate impact of the retirement contribution increases on the County and were not breaches of the Board's fiduciary duty of loyalty to StanCERA members.

Second, the Court noted "several relevant opinions" that Nossaman attorney Peter Mixon, serving as an expert witness to StanCERA and the County, provided with respect to the Board's fiduciary obligations, as follows:

> The first was that the board's transfer of $50 million in April 2009 was consistent with their fiduciary duties. Mixon opined the board "followed a prudent process" by hiring well-qualified and appropriate experts, including an actuarial firm and outside fiduciary counsel, holding public meetings, and ultimately relying on their expert's advice and opinions.
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> He further opined that the decision satisfied the board's duty of loyalty. On this point, Mixon focused on the nature of the nonvaluation reserves and the fact the money did not fund earned benefits and thus was spent at the discretion of the board. Mixon opined that moving these funds to support earned benefits fulfilled the purposes of the StanCERA trust in part by enhancing the security of the vested benefits, was in the best interests of the members and the beneficiaries, and thus satisfied the duty of loyalty. Mixon acknowledged that the transfer had the collateral benefit of lowering employer contributions but opined that such collateral effects are not violations of the duty of loyalty. He compared the effect to regularly accepted practices like asset smoothing, where losses are averaged over multiple years to aid with employer planning, and limited partnership investments, where returns may be split between the plan and a general partner.
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> Mixon next opined that the $10 million, approximately $21 million, and roughly $15 million employee payment offsets made between 2009 and 2011 were also consistent with the board's fiduciary duties. Mixon provided the same basis for his opinion, that the use of nonvaluation funds to support earned, rather than unearned, benefits is entirely consistent with the purpose of the StanCERA trust.
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> Turning briefly to whether StanCERA could, consistent with their duty of loyalty, consider members' jobs when decisionmaking, Mixon opined such considerations were proper. Mixon noted that he was aware of County's statements that it was having budget issues and would have to resort to layoffs. Mixon pointed out that all fulltime employees are members of the retirement system and, thus, should have their interests considered. Relatedly, Mixon opined that considering County's potential credit worthiness if action is not taken would also be appropriate. If the board's actions resulted in County refusing or being unable to pay its employer contributions, members' interests would be harmed.
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> Finally, Mixon opined that adopting a 30-year, level percent of pay amortization schedule was also consistent with the board's fiduciary duties. For this opinion, Mixon focused primarily on the fact the board retained and followed the advice of an expert actuarial firm in making its decision.

Third, the Court also discussed at some length the testimony of StanCERA's consulting actuary, Graham Schmidt, who testified both as a percipient witness and as an expert. The Court focused primarily on plaintiffs' objections to actuary Schmidt's testimony on "undisclosed" expert opinions and overruled those objections, concluding that the trial court was correct that Schmidt's "position as the actuarial adviser for a party to the case entitles him to render opinions concerning the actuarial soundness of the plan that we're dealing with." The Court also noted that based on this ruling, Schmidt went on to testify at trial "about the types of factors an actuary looks at when certifying results, including potential planning abilities of entities whose budgets are affected by the actuarial calculations." The Court explained that Schmidt was asked to discuss "the meaning of the actuarial certifications" he made after providing actuarial valuations to

StanCERA. Importantly, the Court observed with respect to actuary Schmidt's testimony:

> When asked if he could certify a report that required actuarially unsound employer contributions, Schmidt stated he could but would need to disclose that the plan would not be able to fund the benefits as promised. Schmidt confirmed none of his reports had ever made such a disclosure and, when asked if this meant the plans were actuarially sound, stated his signature meant that if the assumptions made were met, "the contributions designated for the employer and the employees will be able to fund the benefits as promised." To Schmidt, this is what actuarial soundness meant.
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> Accordingly, Schmidt answered affirmatively when asked whether the plan was actuarially sound and confirmed that there were no actuarial rules against implementing negative amortization schedules.
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> Schmidt also provided explanations regarding the meaning of plan funding ratios, actuarial soundness, and the effect of employers not paying their contributions. Ultimately, Schmidt opined that the board's actions were actuarially sound and that he would have disclosed any actuarial concerns he had with the board's actions if any had arisen.

Three takeaways from *O'Neal III* strike us as worthy of note.

First, the "prudent process" in which retirement boards consider input of their qualified expert advisors, deliberate and ultimately rely upon that advice held up to substantial judicial review.

Second, both the trial court and the court of appeal focused heavily on the *purpose* of the StanCERA Board having made the five challenged decisions and determined that because those decisions were, in large part, intended to "enhance the security of vested benefits" they were not violations of the Board's duties of loyalty or prudence.

Third, both courts found the testimony of StanCERA's consulting actuary regarding the mechanics and consequences of the five challenged decisions for StanCERA and its members to have significant probative value when discerning whether they were permissible as a matter of fiduciary law.

As retirement system trustees and staff grapple with the challenge of maintaining actuarially sound public retirement systems given the uncertainties in the markets, and the equally difficult challenge of balancing the competing interests of the retirement system's active, deferred and retired members who all may have different interests with respect to their interactions with the retirement system, these three takeaways may hold them in good stead.