

NORMAN T. SELTZER
ROBERT CAPLAN
GERALD L. MCMAHON
REGINALD A. VITEK
STEPHEN DOUGLAS ROYER
DAVID J. DORNE
JAMES R. DAWE
BRIAN T. SELTZER
ELIZABETH A. SMITH
JOYCE A. MCCOY
DENNIS J. WICKHAM
JOHN H. ALSPAUGH
JAMES P. DELPHEY
ELINOR T. MERIDETH
MICHAEL G. NARDI
THOMAS F. STEINKE
NEAL P. PANISH
SEAN T. HARGADEN
DAVID S. MINTON
DAVID J. ZUSKOFF
CHARLES L. GOLDBERG
PATRICK G. HALL
MICHAEL A. LEONE
DANIEL A. ANDRIST
J. SCOTT SCHEPER
LEE E. HEJMANOWSKI
DANIEL E. EATON
LAURA H. ROPPE
M. CHRISTINE TENNISON
ANDREW D. BROOKS
PAUL R. DATNOW
JOHN M. TOSCANO
MARNIE S. SKEEN
DAVID M. GREELEY
TROY A. KINGSHAVEN
CHARLES B. WITHAM
RHONDA K. CRANDALL
JACK R. LEER
JEFFREY B. HARRIS
SCOTT A. MILLER
KEVIN J. REISCH
LANCE GORDON ISEN
ROBERT (ROBIN) M. TRAYLOR
MATTHEW M. MAHONEY
JOSEPH D. RASKIN
ELIZABETH B. CHARAPP
JASON A. HELSEL
JOSEPH P. MARTINEZ
AMANDA L. KRAMER
JOHN C. DINEEN

OF COUNSEL
VICTOR A. VILAPLANA
LINDA PAPST DE LEON
MONTY A. MCINTYRE
G. KIRK ELLIS
GREGORY A. VEGA
HOWARD J. BARNHORST II
JOHN E. BARRY

www.scmv.com 2100 SYMPHONY TOWERS
619.685.3003 750 B STREET
619.685.3100 FAX SAN DIEGO, CALIFORNIA 92101

REGINALD A. VITEK, ESQ.

vitek@scmv.com
619.685.3075
619.702.6804 FAX

SELTZER | CAPLAN | MCMAHON | VITEK
A LAW CORPORATION

March 5, 2003

VIA HAND DELIVERY

Sheila Leone, Esq.
San Diego City Employees'
Retirement System
410 B Street, Suite 400
San Diego, CA 92101

Re: San Diego City Employees' Retirement System, et al. adv. James F.
Gleason, et al. - Initial Litigation Evaluation and Recommendations
San Diego Superior Court Case No. GIC 803779
Our File No. 7835.56570

Dear Sheila:

We have now had an opportunity to conduct an initial review and evaluation of certain documents pertaining to actions taken by the San Diego City Employees' Retirement System ("SDCERS"), by and through its individual board members ("the Individual Defendants") which serve as the factual foundation of the *Gleason* litigation. The categories of documents we have reviewed include:

- (a) The *Gleason* complaint;
- (b) Correspondence to and from SDCERS' fiduciary counsel regarding the 1996 City Manager's Retirement Proposal ("the '96 Agreement");
- (c) Memoranda from the City of San Diego City Manager's Office regarding the '96 Agreement;
- (d) Memoranda from the City Manager's Office regarding the City Manager's May 2002 contribution reduction proposal ("the '02 Proposal");
- (e) Draft and final correspondence, and presentation materials, from SDCERS' fiduciary counsel regarding the '02 Proposal;
- (f) SDCERS Staff Report regarding the '02 Proposal;

*ADMITTED IN NEW JERSEY ONLY

SDC075670

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 2

- (g) Correspondence and presentation materials prepared by SDCERS' actuary regarding the '02 Proposal;
- (h) Minutes of the SDCERS Board of Directors meetings on September 20, 2002, and November 15, 2002;
- (i) Transcripts of the SDCERS Board of Directors meetings on June 21, 2002, July 11, 2002, and November 15, 2002;
- (j) Agreement dated November 18, 2002, regarding Employer Contributions between the City of San Diego and SDCERS, including related resolutions regarding defense and indemnity of the Individual Defendants;
- (k) Draft report on the Mayor's Blue Ribbon Committee on City Finances, dated January 15, 2003, including SDCERS staff response, and final version of "Blue Ribbon Committee" report, dated February 11, 2003.

We have also interviewed SDCERS' actuary, Rick Roeder, and spoken briefly with its fiduciary counsel, Bob Blum, Esq. We will meet with Mr. Blum to discuss his knowledge of the facts involved in this case on March 13, 2003. Finally, we have performed preliminary legal research to familiarize ourselves with the law governing SDCERS' rights, duties and obligations regarding the conduct at issue in the *Gleason* litigation.

Based on the foregoing sources of information, as well as our informal discussions with SDCERS staff, this letter will provide you with our initial analysis and recommendations regarding the defense of SDCERS in the *Gleason* litigation. As you know, our engagement is limited to representation of SDCERS, and does not include *any* of its board members, whether such board members are among the class of Individual Defendants or not. Moreover, our analysis, conclusions and recommendations are made exclusively from our perspective as litigation counsel. While we understand the *Gleason* litigation implicates highly politicized issues, our analysis does not take such factors into account, and instead focuses solely on what we believe is the litigation strategy mostly likely to achieve the best possible result for SDCERS.

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 3

Summary of Conclusions and Recommendations

Our conclusions and recommendations, as set forth in detail in this letter, are:

1. The Individual Defendants breached their fiduciary duty by adopting the '02 Proposal in its modified form because it resulted in a lower contribution obligation by the City, as well as an increase in vested liabilities, without any basis for accepting the City's contention that it would meet its increased contribution obligations in the final years covered by the '02 Proposal. It is unclear whether plaintiffs are asserting a breach of fiduciary duty by SDCERS, as contrasted with its Board.
2. The Individual Defendants subordinated SDCERS' interests to the interests of themselves, their unions, and the City.
3. SDCERS Staff should recommend to the Board that it exercise its right under the November 18, 2002 Agreement to "nullify this Agreement to the extent required by its duties established under the California Constitution..."
4. Notwithstanding the foregoing conclusions, SDCERS may be immune from liability for the acts alleged in the complaint under Government Code section 815.2. Depending on the strategy adopted after discussion between SDCERS and its litigation counsel, the initial responsive pleading may be a demurrer to the Complaint seeking dismissal of the action against SDCERS on the grounds it is immune from liability.
5. In the event it is necessary to answer the Complaint in the *Gleason* litigation, SDCERS should consider filing a cross-complaints against the City of San Diego and the labor unions whose leadership voted for the '02 Proposal, alleging a conspiracy between the City and Unions to cause the Board members to breach their fiduciary duties to SDCERS' members and their beneficiaries.
6. SDCERS should adopt a litigation strategy in the *Gleason* litigation designed to cause the City to honor its contribution obligations under the '96 Agreement.

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 4

Summary and Analysis of the Facts

B. The '96 Agreement.

In or about June 1996, the City Manager proposed an "Employer Contribution Rate Stabilization Plan," under which contribution rates would be calculated using the projected unit credit (PUC) actuarial method, with specified contribution rates in the ensuing two fiscal years of 7.08% and 7.33%. Thereafter, the contribution rate would increase by 0.50% each year until the contribution rate reached the rate calculated on the basis of the entry age normal (EAN) actuarial method. Significantly, the City Manager's proposal specified:

"In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation...the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation."

The City Manager's stated reason for presenting the "Rate Stabilization Plan" was the unanticipated fluctuations in the Employer's Contribution Rate under the projected unit credit actuarial method adopted by the City in 1992. Thus, all parties knew the City Manager's proposal was intended to effect changes to the retirement system *for the benefit of the City*.

The question of whether the Board would be discharging its fiduciary duties in adopting the '96 Agreement was submitted to fiduciary counsel for an opinion. Counsel noted that nothing in the proposal "changes the Board's discretion to adjust the actuarial assumptions on which the System is based as needed in order to insure the long term funding integrity of the System." Counsel concluded:

"Provided the City-paid rate in the [Plan] is not less than an amount substantially equal to that required of employees for normal retirement allowances as certified by the actuary, the Board will be acting within the discretion granted to the Board to

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 5

administer the System and discharging its fiduciary duties set forth in Article XVI, Sec. 17 of the California Constitution.”

In response to questions from members of the Board, fiduciary counsel issued a second opinion addressing the System’s duties under *Claypool v. Wilson* (1992) 4 Cal.App.4th 646, and related cases, to ensure that the modification of vested pension rights which would result from adoption of the City Manager’s proposal were “offset” by an “increase in benefits and other advantages granted to the beneficiaries” of the System. Counsel noted that other aspects of the City Manager’s proposal conferred increased benefits on the System’s members. This, combined with the conclusion that “stabilization of employer contribution rates is directly related to the functioning and integrity of the system, led counsel to conclude the Board was acting in a manner consistent with its duties under *Claypool*.

In its second opinion letter, fiduciary counsel addressed two additional issues raised by Board members, which remain relevant to the current litigation. First, counsel noted the Board is held to the standard of professional bankers and bank investment advisors, and therefore has “a duty to determine the financial viability of the City before it approves contribution payments at a level less than that recommended by the actuary.” Failure to carry out this duty, counsel noted, would be a breach of fiduciary duty. After reviewing the available information, counsel concluded a process existed through which the Board could satisfy itself of the City’s financial viability.

Next, counsel noted that, because “the Board has no authority to determine benefits or to make benefit changes,” it “should not engage in negotiations for benefit changes or increases.” Nonetheless, certain Board members inquired as to whether the “real conflict” presented by Board members voting on proposals which would confer financial benefits on themselves would prevent those Board members from voting on the proposal. Fiduciary counsel noted that the City Manager’s proposal made adoption of increased benefits contingent on approval of reduction of the City’s funding obligation. However, counsel noted the drafters of the City Charter through which SDCERS was established “were aware of possible conflicts of interest inherent in the appointment of those [financially interested] members of the Board.” Under these circumstances, counsel opined, the “bare potential for a conflict of interest does not categorically bar a fiduciary from functioning as a trustee.” On this basis, counsel concluded:

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 6

“[I]t is our opinion that those Board members who voted in favor of the proposal solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system, did not have a conflict of interest sufficient to bar him or her from functioning as a trustee.”

According to Mr. Roeder, the performance of relevant financial markets during the 1996 through 2000 time frame caused the funding ratio to far exceed the “trigger” established by adoption of the '96 Agreement. Mr. Roeder noted it was generally accepted that the funding ratio trigger was 82.3%, but because the funding ratio never approached that level, certain potential ambiguities in the '96 Agreement were never resolved.

C. The 2002 City Manager's Proposal.

On June 10, 2002, the City Manager, on behalf of the Mayor and City Council, requested that SDCERS approve an amendment to the '96 Agreement as follows:

“The floor for the actuarial funded ratio of SDCERS will be established at 75%.

The City will pay contributions at the ‘agreed to’ rates for FY96 through FY07 as contained in the Manager's Proposal. If the actuarial funded ratio falls below the floor in any year, the City will increase its contribution rate on July 1 of the following year by an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent for years in order to achieve the full actuarial rate over a five year period.”

The City Manager identified as the basis for the proposed amendment several “unprecedented events” during the preceding two years, including 9/11, “the collapse of the dot com industry,” the “overall fall in the investment market,” the “specific loss of revenues in the San Diego economy, and the anticipated raid on local revenues by the State of California.”

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 7

During the following week, SDCERS requested an opinion from its current fiduciary counsel, Bob Blum, Esq., as to whether adoption of the City Manager's proposal was consistent with the Board's fiduciary duties. In an unsigned draft opinion letter dated June 12, 2002, Mr. Blum summarized the circumstances which led to the City Manager's proposal, including: the total of contributions by the City and members to SDCERS was insufficient to cover the normal cost and interest on past service cost computed at the actuarial funding rate; from July 1996 to June 2002, the difference between actual City contributions and actuarially calculated contributions totaled approximately \$90 million; and, "it is estimated that as of June 30, 2002, SDCERS funding ratio will be close to 82.3%."

Mr. Blum noted that since the '96 Agreement was executed, the law governing employees' interests in their retirement system had been "substantially strengthened," thus limiting the ability of employers to alter contribution obligations in a manner that affected vested benefits. Moreover, Mr. Blum noted that the ability to "mitigate" funding reductions through provision of "comparable new benefits" was "not governing with respect to the Board's responsibility to act prudently. If it were governing then each time that employer persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. That would not pass elementary actuarial requirements." Significantly, Mr. Blum noted that one of the questions left unanswered by the City Manager's proposal was the means by which the City would fund its contribution obligation under the proposed modification to the '96 Agreement.

After more than a dozen pages of analysis, counsel concluded:

"Under the facts as we understand them, and for the reasons discussed above, it is our opinion that there is a material risk that if the Board were to agree to the proposed amendment to the Manager's Proposal in its current form, and if this decision were challenged in court, a court would hold that the decision was not a proper exercise of the Board's fiduciary responsibilities based upon the facts before the Board and the actuaries [sic] opinion to the contrary. A court would look at whether the Board had substantial evidence to support the propriety of its actions and there is a material risk that a court would find such evidence lacking." (Emphasis added.)

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 8

Also on June 12, 2002, SDCERS' actuary, Rick Roeder, made a presentation to the Board which was highly critical of the '02 Proposal. Among the most important points Mr. Roeder made were the fundamental inconsistency, from SDCERS' point of view, between the "enhanced benefits" aspect of the proposal, and the "contribution relief" aspect of the proposal. Mr. Roeder also laid out the following facts, which he felt were relevant to the Board's decision:

- (a) SDCERS' role should be largely independent of the setting of existing or potential benefit levels;
- (b) Existing benefits for City employees were not below average compared to other state and national public systems;
- (c) SDCERS is one of the few retirement systems to use PUC funding, and on that basis has one of the lowest funded ratios in California; moreover the existing funded ratio is at its lowest point since the 1980's; and
- (d) The gap between the computed PUC actuarial rate and the city contribution rate has been increasing since implementation of the '96 proposal.

Mr. Roeder also noted several mitigating factors. Foremost among them, it appears, was that SDCERS would "be able to make benefit payments over the next 10-15 years regardless of the decision made to grant potential additional funding relief."

In his presentation to the Board, Mr. Roeder stated, "What the City proposes is outside the norm for generally accepted actuarial funded policies," a circumstance which he felt "place[d] an added burden in our view as trustees to exercise our fiduciary responsibility appropriately." Mr. Roeder stated that if the Board was "willing to accept this version of the manager's proposal, I want everyone here to be totally cognizant of the fact that the way I understand the current version is it will [be] possible for the funded ratio to go below 75 percent and possibly significantly below." Finally, Mr. Roeder made clear he was more comfortable with the initial manager's proposal because of the "hard floor" of 82.3%

Transcripts of the June 2002 hearing indicate a difference of opinion existed among both Board members and Staff regarding the proper interpretation of the '96 Agreement's "catch-up" provisions; particularly, whether the entire underfunded

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 9

amount came due in the immediately following year, or whether some longer term applied. Mr. Blum, along with Mr. Roeder, noted that under reasonably anticipated circumstances, a one-year catch-up provision would require the City to contribute approximately \$75 million in FY03, if the funded ratio fell below 82.3%, as it was expected to do.

On June 18, 2002, the City Manager issued a memorandum to SDCERS purporting to respond to concerns raised by Mr. Blum in his June 12 draft correspondence. There appears to have been no attempt to respond to Mr. Roeder's concerns as expressed in his presentation. Significantly, despite Mr. Roeder's concerns over "dropping the hard floor" from 82.3% to 75%, the City Manager's memorandum left that provision unchanged. Additionally, the City Manager responded to Mr. Blum's concern regarding "funding status and anticipated earnings" over the later stages of the '02 Proposal's life by stating:

"This is a very broad question which includes the work initiated by the Mayor's Blue Ribbon Committee on City Finances, the SDCERS subcommittee on surplus earnings and contingent benefits, and the need to develop a long term funding policy. It is recommended that a plan and schedule be developed to complete this policy work."

The only substantive modification to the original proposal was an increase in the City's "agreed contribution rate" from 0.50% to 1.00% effective July 1, 2004. This proposal is, at the very least, puzzling in light of the City Manager's non-response to Mr. Blum's questions concerning financing, and the City's purported justification for seeking contribution reduction in the first place, i.e., that it expected the State to "raid" City revenue sources beginning in 2004, thus worsening its short-term financial outlook.

On July 3, 2002, the City Manager provided SDCERS with another memorandum "clarifying" the terms of the proposal, as well as responding to concerns by Board members. Significantly, the City Manager's "clarification" made clear that the City had agreed to increased benefits for its employees during labor negotiations, "contingent" upon SDCERS accepting a reduction of its contribution obligation; yet in response to a Board member's question as to why SDCERS was placed in the middle of labor negotiations, the City Manager denied such a thing had occurred. Also significant was the City Manager's response to the Board's question of "why

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 10

we should assume the City will find it easier to pay much higher pension costs in the future:"

"It will not be easier nor desirous, just necessary."

No further information was provided as to how the City would meet the contribution obligation outlined in its proposal.

On July 11, 2002, another Board meeting was held at which SDCERS' fiduciary counsel provided an analysis of the effect of the "changes" the City offered in an effort to gain acceptance of the '02 Proposal. Mr. Roeder made clear at the July 11 meeting that the 82.3% trigger would be hit in June 2003. Thereafter, the Board devoted its discussion to the difference in funding obligations between competing interpretations of the '96 Agreement and the '02 Proposal. After lengthy and detailed discussions, Mr. Saathoff proposed that the 75% trigger in the '02 Proposal be replaced with the existing 82.3% trigger. Additionally, the modified proposal would incorporate the provision in the original '02 Proposal giving the City five years after the trigger was hit to "reach the full actuarial rate."

In the final minutes of what was a very long meeting, before a vote was taken, the Board asked both Mr. Roeder and Mr. Blum whether adopting the proposal was "a prudent exercise of our responsibility." Mr. Roeder appears to have responded that the final version of the proposal fell somewhere between the '96 Agreement and the original '02 Proposal. Mr. Blum stated it was difficult to give "an on-the-fly opinion," before concluding:

"I can tell you it's a lot easier to give an opinion that you would not be at material risk. Exactly how far that opinion can go, exactly what the words are, that's a little difficult to tell you because we don't have the facts."

A vote was taken immediately thereafter, in which the modified '02 Proposal passed 8 to 2, with one abstention.

On November 5, 2002, Mr. Roeder provided certain written "statements in regard to the amendment to the Manager's Proposal." From the perspective of the current litigation, the most significant statements Mr. Roeder made were:

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 11

“(c) It is likely that the 82.3% trigger point will be hit by June 30, 2003,...”

“(d) The higher the City's contribution levels, the better the funding status of SDCERS...”

“(g) From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger (particularly if one of the two 'high contribution rate' interpretations of the effects of hitting the trigger were to prevail).”

Mr. Roeder's letter did not include any statement to the effect that adoption of the modified '02 Proposal conformed to generally accepted actuarial principles, or that it was a prudent exercise of the Board's fiduciary responsibility.

On November 15, 2002, Mr. Blum reported to the Board on the results of his negotiation with City representatives on the provisions of the Memorandum of Understanding that set forth the final terms of the modified '02 Proposal. The Board discussion centered on assumptions underlying the exemplar calculations in the Memorandum of Understanding. Additionally, the first mention was made of “indemnification” of the Board by the City from unspecified consequences of adopting the modified '02 Proposal. Transcripts of the hearing indicate the discussion became extremely contentious and acrimonious. It appears from both the minutes and transcript that the Board concluded Mr. Blum essentially supported adoption of the MOU because the Board had engaged in prolonged and difficult evaluation of the proposal before adopting it. However, at least one Board member acknowledged that Mr. Roeder was “hesitant” to endorse the proposal. Mr. Roeder confirmed this interpretation of his feelings, stating that he felt it was “inappropriate” and placed the Board in “a no-win situation” of evaluating a contribution relief proposal that was linked to enhanced benefits for members. Nonetheless, the Board voted to adopt the MOU.

On November 18, 2002, Mr. Blum provided SDCERS with a signed opinion letter, containing an extensive, albeit retrospective, summary and analysis of the Board's decision to approve the modified '02 Proposal. Mr. Blum summarized the Board's decision as follows:

“In essence, the Board decided to trade potential controversy over the meaning of the current Manager's Proposal and the possibility of receiving substantially higher contributions from the City if the

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 12

82.3% trigger is met in exchange for materially higher contributions if the trigger is not hit, lower contributions in the first five years if the trigger is hit, a date certain when the full PUC rate is contributed, and agreement on rapid movement to EAN starting at the end of the transition period.”

Despite Mr. Roeder's multiple criticisms of the '02 Proposal (see page 11), Mr. Blum's only mention of Mr. Roeder's analysis was that the “transition period of moving the City to full PUC rates and then to EAN rates is reasonable based on the terms of the Agreement.” Mr. Blum's reference to this limited aspect of Mr. Roeder's overall conclusion is puzzling, since Mr. Roeder explicitly stated that “from a purely actuarial viewpoint,” he preferred there be no transition period.

On November 18, 2002, SDCERS executed the Agreement adopting the modified '02 Proposal. Significantly, the recitals included a statement that SDCERS recognized that “under current fiscal circumstances, undue hardship would be imposed on the City if the Board were to require that the City immediately increase its contributions to the full projected unit credit rate calculated by SDCERS' actuary.” Also significant was a previously little-discussed provision allowing the Board to “nullify this Agreement to the extent required by its duties established under the California Constitution and no one shall have any liability for losses or costs on account of such action.”

On the same date, SDCERS and the City executed an indemnity agreement, which provided “the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members under the Charter.”

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 13

Summary of the Litigation

D. The Complaint.

The *Gleason* litigation was filed by attorney Michael Conger on January 16, 2003. Plaintiffs are by two retired San Diego City employees, purportedly acting on behalf of an alleged class of similarly situated retired San Diego City employees. Defendants are the City of San Diego, SDCERS, and certain members of the Board of SDCERS, including Frederick Pierce, IV, John Torres, John Casey, David Crow, Mary Vattimo, Ron Saathoff, Terri Webster, Sharon Wilkinson, Dick Vortmann, and Ray Garnica (collectively: "the Individual Defendants").

The lawsuit alleges the City of San Diego violated certain sections of its Charter, as well as related sections of the City of San Diego Municipal Code, by failing and refusing to contribute actuarially appropriate amounts to SDCERS. Specifically, the lawsuit alleges "[t]he funding method adopted by CERS [sic] and the individual defendants is not one of the six approved funding methods permitted under the rules set forth by the Governmental Accounting Standards Board." The allegations focus primarily on the City's alleged violation of the cited provisions of its Charter and Municipal Code by failing to contribute funds to SDCERS according to the terms of the '96 Agreement, and thereafter obtaining a greater reduction of its contribution obligation through the adoption of the '02 Proposal.

The lawsuit seeks declaratory relief in the form of a judgment that the City violated the terms of its Charter and relevant provisions of its Municipal Code, and that SDCERS' Board and the Individual Defendants breached fiduciary duties owed to the plaintiff class. The lawsuit also seeks restitution from the City of San Diego of all amounts owed to SDCERS as a result of past violations (an amount estimated in the hundreds of millions of dollars), injunctive relief prohibiting further unlawful underfunding, money damages for retirement benefits which would have been paid to the purported plaintiff class but for the alleged violations, money damages from the Individual Defendants for damages proximately caused by their alleged breach of fiduciary duty, and removal of the Individual Defendants from the Board of SDCERS.

E. SDCERS Proposed Response to the Complaint.

The complaint makes clear that both the Individual Defendants, as members of the SDCERS Board, acted in their official capacity when they entered into the Agreement which is the subject of the *Gleason* litigation. For this reason, we think

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 14

that both the Individual Defendants, and SDCERS, may be immune from liability for the conduct at issue in the complaint, pursuant to Government Code sections 820.2, 821, and 815.2, respectively. We are presently researching whether any exceptions exist to these immunity statutes based on the nature of the alleged misconduct. If no such exceptions exist, it may be appropriate to demur to the complaint.

Before making this decision, however, consideration should be given to whether it is in SDCERS' best interests to extricate itself from the litigation at this early stage. While this may seem on its face to be counterintuitive, the underlying reasoning is as follows. The plaintiffs' objective is primarily to obtain funds from the City, both in the form of past contributions which were "wrongfully withheld," and increased future contributions. To the extent the complaint could achieve this form of relief, SDCERS would benefit. If SDCERS were to extricate itself from the litigation at the pleading stage, it would lose its status as a party, and its ability to affect the outcome of the litigation, which likely will be accomplished through the mediation process. Of course, the litigation would proceed against the City; therefore, the potential benefit to SDCERS from a judgment in favor of the plaintiffs would not disappear should SDCERS successfully demur to the complaint. Nonetheless, as you are aware, not being present at the "mediation table" with the City can have serious adverse consequences for SDCERS.

By electing not to demur to the complaint, SDCERS would not lose its ability to raise the immunity statutes as a defense. Such statutes can be pleaded as affirmative defenses in an answer, and thereafter be used as the basis for a motion for summary judgment which could be filed in the event early mediation proved unsuccessful. We intend to discuss this strategic decision with you in further detail once you have had an opportunity to review this letter.

F. Post-Demurrer Litigation Analysis

While we believe a reasonable probability exists that this matter could be dismissed as to SDCERS at the pleading or summary judgment stage, it nonetheless is necessary to advise you of our opinions as they relate to issues likely to arise in the post-pleading phase, should the case advance that far.

In the event the Court concludes SDCERS is not immune from liability, it will be necessary to answer the complaint and proceed with discovery. At the time the answer is filed, however, consideration should be given to filing a cross-complaint

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 15

alleging conspiracy between the City and Unions to cause SDCERS' Board members to breach their fiduciary duties to its members and their beneficiaries. While this may seem antithetical to SDCERS' custom and practice in its dealings with the City, it highlights the significantly different circumstances forced on SDCERS by the filing of the *Gleason* litigation.

As we advised in the preceding section, SDCERS' interests arguably are aligned with plaintiffs' interests, at least to the extent that increased contributions by the City would benefit SDCERS. However, although SDCERS' interests are aligned with plaintiffs', its status as a defendant does not allow it to control the manner in which claims for such relief are prosecuted. For example, plaintiff counsel could settle with the City on the basis of ill-defined promises of future remedial action, combined with a large amount of attorney's fees for procuring such "relief." Under such circumstances, SDCERS would gain none of the advantage from the litigation to which it is arguably entitled. Filing a cross-complaint would confer standing on SDCERS to control the manner in which relief is sought, and potentially granted, rather than relying on plaintiffs to obtain all appropriate relief.

A cross-complaint against the City and Unions would be based on information that indicates certain union representatives obtained benefits for themselves and co-members of their union as part of the negotiation process over adoption of the modified '02 Manager's Proposal. If proven, this would support the conclusion that these individuals breached their fiduciary duty to SDCERS by approving a plan which included enhanced short-term benefits for themselves, while at the same time allowing the City to reduce its contribution to SDCERS.

Our recommendation in this regard also results in part from our conclusion that SDCERS Board members breached their fiduciary duty by executing the November 18, 2002 Agreement. As you are well aware, the California Constitution requires SDCERS Board members must discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries, while also minimizing employer contributions and defraying reasonable expenses of administering the system. However, where these objectives conflict, the duty to participants and beneficiaries takes precedence over any other duty. Based on our analysis of the available information, we believe a trier of fact would conclude that the only party to the November 18 Agreement that obtained any benefit therefrom was the City, in the form of long-term contribution relief. All available actuarial analyses show SDCERS will receive substantially less money under any version of the '02 Manager's Proposal, when compared to the '96 proposal. Parenthetically,

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 16

we believe the justification for adopting the '02 Proposal based on avoiding "uncertainty" over the terms of the '96 Agreement is insufficient to justify adoption of the '02 Proposal. Regardless of which interpretation was applied to the '96 Agreement, if SDCERS stood to gain between \$25 and \$75 million based on what its actuary and fiduciary thought was a reasonable interpretation of the '96 Agreement, it is difficult to accept the proposition that an "advantage" was gained by agreeing to a proposal that not only abandoned the arguable right to a \$25 to \$75 million contribution, but locked in a significant reduction in contributions over the following 8 years.

In addition to agreeing to a reduction in the City's contributions, SDCERS Board members accepted the November 18 agreement knowing its acceptance was a prerequisite to the City's agreement to pay increased benefits to certain of its unions. Thus, the Board agreed to a proposal that not only increased the vested benefits for which it was or would become liable, but at the same time impaired SDCERS ability to meet those obligations by accepting a reduced contribution obligation by the City.

Further on this issue, there appears to have been only limited inquiry into the means by which the City would ramp up its contributions over the term of the November 18 Agreement to meet the "agreed" contribution rate by 2009. The record shows the City sought contribution relief because of the near-certainty that the 82.3% funding ratio trigger would be hit by June 2003. Moreover, the City provided further justification for the requested contribution relief in the form of statements to the effect that its revenue in 2004 would be even less than in 2003, by virtue of the State "raiding" the City's revenue sources to pay for its own budget deficit. As SDCERS' fiduciary advised it when the '96 Agreement was adopted, the Board members are held to the standard of a professional banker, and must evaluate the financial condition of the City, before agreeing to grant it what amounts to debt relief. Yet here, the City offered no information to support its contention that it would somehow be able to contribute more to SDCERS between 2005 and 2009 than it ever had in the past, and thus reach the actuarially calculated contribution rate by 2009.

We anticipate that regardless of whether SDCERS prevails at the pleading or dispositive motion stage, and thus is no longer a party to the litigation, the foregoing facts nonetheless will come out in discovery. Our review of the record leads us to conclude little, if any, evidence exists that Mr. Roeder provided the necessary actuarial support for the Board's adoption of the '02 Proposal. Our

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 17

interview with Mr. Roeder confirmed this conclusion. We anticipate that when plaintiffs depose Mr. Roeder, he will testify that the November 18 Agreement was not based on actuarially sound conclusions, and that it will result in substantially lower contributions by the City to SDCERS than would have resulted had the '96 Agreement remained effective.

We have not yet had an opportunity to interview Mr. Blum and Ms. Hiatt. Therefore, we have not been able to ascertain what substantive changes to the initial '02 Proposal convinced them to change their draft opinion, which stated adoption of the '02 Proposal would be a breach of SDCERS' Board members' fiduciary duty, to their November 18 opinion, which appears to support the Board's decision. The absence of clear and specific facts supporting this turnabout leads us to conclude Mr. Blum's final opinion letter may be insufficient to protect SDCERS Board members from a finding that they breached their fiduciary duty.

Conclusion and Recommendations

The record we have reviewed clearly shows SDCERS was backed into a corner by the City, which agreed to provide enhanced benefits to its union members, and thereafter sought to "pay" for these benefits through reduction of its contributions to SDCERS. The City's enhanced benefits proposal to its unions was expressly contingent on SDCERS' agreement to reduction in the City's contributions. In essence, the City and unions forced SDCERS into precisely the circumstance its fiduciary counsel and actuary considered highly improper: linking benefit enhancement with contribution relief. Furthermore, the inherent and recognized conflict under which certain SDCERS Board members operate appears to have been exacerbated by the inclusion of additional benefits for those Board members during the negotiation process.

To avoid a continuation of this inherent conflict during our representation of SDCERS in the *Gleason* litigation, we recommend SDCERS form a litigation committee to direct its defense of this litigation. Our review of SDCERS' Charter indicates it cannot act without a quorum of its Board. In light of the fact the majority of its Board are Individual Defendants, and are separately represented, the composition of the litigation committee is a difficult question, and lacks clear precedent. Nonetheless, we believe the committee should be comprised of the Board president, at least one senior Staff member and Staff counsel, and Board members who have the fewest possible ties to either the City or the unions. This would allow a relatively "disinterested" litigation committee to make

Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 18

recommendations to the Board on important decisions to be made in defending against the *Gleason* litigation. In this manner, the influence of “interested” (and potentially conflicted) parties would be at least minimized, thus increasing SDCERS’ ability to defend this action in a manner consistent with its Constitutional mandate.

If the “litigation committee” format proves unworkable, SDCERS may be able to adopt a course of action similar to that used by corporations defending against derivative lawsuits in which a quorum of disinterested directors cannot be assembled. In such circumstances, the corporation will sometimes hire a “litigation representative” whom it empowers to act on its behalf in directing and controlling the litigation. We have not yet researched whether SDCERS’ rules of governance would permit it to designate an independent third party as its litigation representative in this action, but would be happy to do so if you so choose. Potential candidates for such a position would include retired judges such as Hon. Lawrence Irving, or Hon. Howard Wiener, or other individuals with an outstanding reputation for ethical conduct and business judgment.

In light of our conclusion that SDCERS Board members breached their fiduciary duty to its members and their beneficiaries by executing the November 18 Agreement, we believe it should adopt a litigation strategy designed to obtain an increased contribution obligation from the City. The first step in this process would be to exercise its right under the November 18 Agreement to “nullify” the Agreement. Thereafter, SDCERS should work with its actuary to produce a defined contribution schedule which meets SDCERS’ obligations to its members and their beneficiaries in a manner consistent with other public agencies in this State. This actuarial calculation should then be used as the basis to obtain a new contribution agreement from the City in the context of mediation proceedings in this litigation.

We believe mediation is appropriate in this matter both because it would avoid a finding that SDCERS Board members breached their fiduciary duty to its members, as well as because we believe this will not be the last lawsuit Mr. Conger files as a result of the November 18 Agreement. As members of Staff have made clear to us, SDCERS has sufficient funds to meet its current obligations to the class of retirees. What Mr. Conger appears to not yet appreciate is that the November 18 Agreement compromised the interests of *future* SDCERS members much more than those of *existing* members. That is, from Mr. Conger’s perspective, he has the “right” lawsuit, but the wrong plaintiff class. We suspect this fact will not be lost on Mr.


Sheila Leone, Esq.
Our File No. 7835.56570
March 5, 2003
Page 19

Conger forever. In the meantime, the defendants enjoy a small strategic advantage in developing a strategy that would eliminate the potential for a second lawsuit on these facts while plaintiff counsel remains apparently unaware of the possibility of such a lawsuit. Developing a litigation strategy, as outlined above, that incentivizes the City to cooperate in reaching that goal is therefore of paramount importance.

As everyone is well aware, this is an extremely complicated matter, with ramifications reaching far beyond the limited scope of the *Gleason* litigation itself. We recognize that our analysis and recommendations may be inconsistent with SDCERS' political objectives, and we cannot offer any guidance on how to reconcile the two. Nonetheless, having been forced into litigation over what was originally a political and legislative issue, SDCERS must now formulate a litigation-based strategy for dealing with its current circumstances. After reviewing this letter, we would appreciate an opportunity to meet with appropriate SDCERS representatives to discuss this issue further.

Thank you for your attention to this matter. We look forward to hearing from you.

Very truly yours,

A handwritten signature in black ink, appearing to be 'Reg A. Vitek', with a long horizontal line extending to the right.

Reg A. Vitek
Seltzer Caplan McMahon Vitek
A Law Corporation

MAL/RAV:bs
cc: Michael A. Leone, Esq.