Halverson, Beth

From: Office State Actuary, WA
Subject: FW: Questions regarding the merger survey

From: Jim Adsley [mailto:adsley@whidbey.com]
Sent: Wednesday, July 13, 2016 4:42 PM
To: Gutierrez, Aaron <Aaron.Gutierrez@leg.wa.gov>
Subject: Re: Questions regarding the merger survey

Thanks Aaron.

From: Gutierrez, Aaron
Sent: Wednesday, July 13, 2016 12:57 PM
To: adsley@whidbey.com
Subject: RE: Questions regarding the merger survey

Jim,

I don't know offhand when the LEOFF 1/LEOFF 2 issue was added to the budget bill. As you can see from the legislative history, the bill was amended numerous times (as is typical for a budget bill), and I don't know which amendment added it.

Ultimately, however, the final version of the budget included both LEOFF 1/TRS 1 and LEOFF 1/LEOFF 2 in the study proviso. I mentioned both in my presentation to the SCPP in May.

The reason the survey didn't ask questions specific to LEOFF 1/LEOFF 2 is that the LEOFF 2 Board is has announced that they will be receiving stakeholder input on the LEOFF 1/LEOFF 2 portion through another process. I suggest contacting the LEOFF 2 Board for more information.

As for the actuarial impacts of both a LEOFF 1/TRS 1 merger and a LEOFF 1/LEOFF 2 merger, those are things we plan to analyze for the final report that is due in January. If you'd like more information about our prior merger report (the 2011 Merger Study report), it is available on OSA's website here.

As before, If you have any additional questions or concerns you'd like to add to the stakeholder input for the study, please feel free to send them directly to me or via the survey; whichever you choose.

Thank you,

Aaron

From: Jim Adsley [mailto:adsley@whidbey.com]
Sent: Monday, July 11, 2016 6:14 PM
To: Gutierrez, Aaron <Aaron.Gutierrez@leg.wa.gov>
Cc: Smith, Matt <Matt.Smith@leg.wa.gov>
Subject: Re: Questions regarding the merger survey

Aaron,

I have not yet read 2ESHB 2376 as I was told by others that the Legislative directive to provide further study was for SB6668 and by reason of your not including any questions in the survey other than as related to a LEOFF1/TERS1 merger, I assumed the issue again of a LEOFF1/LEOFF2 merger was a new item. You provided an actuarial review of that proposed merger issue two years ago? You provided a similar review of the LEOFF1/TERS1 merger to the Senate Ways and Means Committee this Spring. It seems to me that the option of a LEOFF1/LEOFF2 merger would have significant impact on the anticipated or forecast result of your actuarial report on SB6668? I believe that others such as Dick Warbruck were also unaware of the LEOFF2 issue until the SCPP meeting in June. Did that issue come up after the Legislative request for the study was presented at the Ways and Means Hearing? Thanks for the response and for forwarding the connection to 2ESHB 2376. I will review it. Jim Adsley

From: Gutierrez, Aaron
Sent: Sunday, July 10, 2016 4:51 PM
To: adsley@whidbey.com
Cc: Smith, Matt
Subject: RE: Questions regarding the merger survey

Jim,

I will gladly add the concerns/questions you mentioned below to the stakeholder feedback we've been receiving through the survey. Thus far we've had over 750 responses to the survey, plus individual emails and phone calls. From those, we've identified several pages worth of questions, and we'll do our best to address as many as possible in our final report.

As for additional background material, I'm hesitant to complicate things with yet another mass emailing. That said, everyone is welcome to view the bill text, history, report, and fiscal note that are available on the Legislature's website here. Please note, however, that the bill that actually created the Merger Study (including adding the LEOFF 1/LEOFF 2 merger update) was the supplemental operating budget bill (2ESHB 2376). The bill report for the budget was slightly over one page and just states a few high level points from a 347-page bill; that's why we included the exact text of the specific budget proviso in the June presentation instead.

As for the round table discussions, Senator Conway mentioned he would be setting those up himself, as opposed to having them set up by SCPP staff. I have been in touch with his office, but thus far do not have any details on how and when those discussions will take place.

If you have any additional questions or concerns you'd like to add, please feel free to send them directly to me or via the survey; whichever you choose.

Thank you,

Aaron Gutierrez, MPA, JD
Senior Policy Analyst
Office of the State Actuary
P.O. Box 40914
Olympia, Washington 98504-0914
http://osa.leg.wa.gov/
Phone 360.786.6152
Fax 360.586.8135

"*Supporting financial security for generations.*"

This e-mail, related attachments, and any response may be subject to public disclosure under state law (Chapter 42.56 RCW).

From: Smith, Matt
Sent: Friday, July 8, 2016 4:08 PM
To: Jim Adsley <adsley@whidbey.com>
Cc: Gutierrez, Aaron <Aaron.Gutierrez@leg.wa.gov>
Subject: RE: Questions regarding the merger survey

Hi Jim,

Thanks for your email. I'll ask Aaron Gutierrez, lead staffer for the merger study, to review your email and respond. Thanks Aaron.

Matt

From: Jim Adsley [mailto:adsley@whidbey.com]
Sent: Friday, July 8, 2016 4:00 PM
To: Smith, Matt <Matt.Smith@leg.wa.gov>
Subject: Questions regarding the merger survey

Matt,

Your presentation before the SCPP on June 21st was very informative. Unfortunately the last minute introduction of a LEOFF1/LEOFF2 merger creates some more questions. I received the survey mentioned in the June 21 meeting on June 28. I reviewed it, however, I have not responded yet as there are the above mentioned new issues/ questions. Senator Conway mentioned some table top meetings which I assumed would happen before the survey. In my view the survey is very basic and with little information for those who have not been aware of, or involved with the TRS/LEOFF1 proposal. Other than the members of the RFFOW and perhaps LEOFF1 Coalition I suspect there is not much knowledge for the majority of LEOFF1 plan members to effectively answer the survey. Perhaps something such as the Senate bill report on SB6668 would have been good to send out with the survey to at least give a snapshot of the proposal. Then the new concept of a LEOFF2 merger adds to that confusion even for those of us who were following the SB6668 proposal.

It seems the primary proposed benefit of the TRS/LEOFF1 merger was to improve the status of TRS1 and reduce the Legislatures and school district costs for contributions to TRS1. It is unclear how a LEOFF1/LEOFF2 merger would meet the objectives of SB6668 and purpose of the required study? In that regard, I have some specific questions.

(1)- What are the current Legislative contributions to the LEOFF2 program?

(2)- Would a merger reduce Legislature contributions to the LEOFF2 plan?

(3)- Would a LEOFF1/LEOFF2 merger provide any direct or indirect benefit for the TRS1 plan shortfall?

(4)- From your presentation on the status of the various funds at the SCPP meeting it appears that the LEOFF1 plan dropped a couple of points and the LEOFF2 plan improved a few points. Would your previous analysis of a LEOFF1/LEOFF2 merger remain substantially the same?

(5)- What is the amount of hard money in each of the three plans?

Since I am unaware of the table top meetings proposed by Senator and the next meeting of the SCPP is near it will be helpful to have an idea about the above questions. Once again, your willingness to respond to questions in this regard is very much appreciated.

Best Regards,

Jim Adsley

From:	Gutierrez, Aaron
To:	Office State Actuary, WA
Subject:	FW: OSA Correspondence - Senate Bill 6668 Study Questions/Comments
Date:	Friday, July 22, 2016 1:24:30 PM

From: Jim Adsley [mailto:adsley@whidbey.com]
Sent: Friday, July 22, 2016 12:33 PM
To: Gutierrez, Aaron <Aaron.Gutierrez@leg.wa.gov>
Subject: Fw: OSA Correspondence - Senate Bill 6668 Study Questions/Comments

Aaron,

As I was reviewing my comments before the meeting this week I discovered a few grammatical errors and missing words which potentially detract from the meaning of my comments. Here is a corrected version showing the highlights if you are planning to include comments as written. Sorry for not reviewing my comments more thoroughly.

By the way, I had signed up to testify at the regular hearing but since I was in the back room apparently my sign up was missed. Having heard the comments from Matt regarding content from clients with interaction with the OSA I wanted to open my comments with a statement I totally agree with that recognition. I did make the brief comment to at least draw attention to the legality of the $5000 contribution while the OSA is requesting legal opinion on the other issues. I have always found interactions with Matt or yourself to be extraordinary as compared to typical public agencies. You guys do a great job. Feel free to include that comment in the report.

Best Regards,

Jim Adsley

From: Jim Adsley
Sent: Monday, July 18, 2016 3:46 PM
To: state.actuary@leg.wa.gov
Subject: OSA Correspondence - Senate Bill 6668 Study Questions/Comments

Honorable Senator Conway and Select Committee on Pension Policy,

By way of introduction I am a retired fire chief from King County. I am retired on the LEOFF1 plan. The survey of various stakeholders by the OSA is appreciated. It is difficult to say whether one is in favor or opposed until the questions/concerns are answered. I assumed that might be facilitated by the round table meetings that were proposed in June. I tried to ask questions before responding to the survey. Without those answers an against response seemed appropriate. Perhaps that can be modified after more complete information of the merger is known.

There were many reasons which lead to the provisions of the LEOFF1 pension system. When that was deemed too rich by the Legislature and LEOFF2 was created the pendulum swung too far in the minimal direction. While many improvements in gear and operations have occurred, the fire service is dangerous resulting in on duty death and higher than average structural and medical problems such as cancer and heart attacks resulting from long term exposure to the elements of the fire ground. One only needs to consider the events of assaults on police officers in the last week to understand the hazards there as well. These are the sensational events you hear about but I see cases of firefighter and police officer deaths every week in professional reports. Emergency services and teaching professions are not similar in this regard. This creates extra emotion to the subject of a LEOFF1/TERS1 merger. For some, subtracting from the emergency services pensions for problems created by different Legislative treatment of teachers is essentially insulting. There are groups in our state who are prospering now, however, at the same time we have more social problems such as homelessness than ever before. The message for many is we are in for some rough times. It creates concern for those on fixed incomes and dependent on a pension.

The following are questions related to the SB6668 proposal. The actuary report is based on pension programs assets and projections or assumptions. I notice a few places in the study where there are disclaimers in that regard.

1- What are the hard money(asset) of the three funds in question versus assumed growth of funds that have not yet materialized?

LEOFF1-

LEOFF2-

TRS1-

2- Is the merger legal in reference to earlier decisions where pension benefits have been diminished?

3- Will the proposal be sent to the IRS for an opinion before a merger is approved by the Legislature?

4- What was the intent of the $5000 one time payment to LEOFF1 members determined by the sponsors of the bill? I have sent a request to Senator Hill’s office in this regard and have not had a response as yet.

5- Has this transfer of a proposed $37.3 Million from the LEOFF1 fund been evaluated for legality? Was the intent to compensate LEOFF1 members for loss as a result of the merger or a gift of public funds?

6- If the one time payment for compensation is for loss then what was the formula for the decision and who made it?

7- It seems that the original intent of SB6668 was to improve the status of the TRS1 shortfall and reduce contributions to that plan from the State and employers. With that in mind does a LEOFF1/LEOFF2 merger that has now entered the review detract from the original intent of the legislation and to what extent?

8- in the earlier reviewed LEOFF1/LEOFF2 merger there was a fall back plan to resolve any developing shortfall by increasing contributions from LEOFF2 revenue sources. In the LEOFF1/TRS1 consideration both plans are closed. How would a specific LEOFF1 plan shortfall be addressed?

9- It is my understanding the State Legislature nor any agencies representing state government have considered the astronomical and growing federal debt (usdebtclock.org), the current related risk to the value of the US dollar, or the current volatility of the US stock market when considering assumptions regarding the funding of pension systems in the future. It also appears we may be headed for another national recession based on recent job offers and second quarter poor sales of many major corporations. It seems over $.40 of every federal dollar is now borrowed which is a figure of the annual deficits in the federal budget. Large players like Microsoft and Boeing are reducing family wage jobs which may effect state tax receipts. Typically, WA is into recessions later and out of them later than other areas of the country. With these issues in mind,

a-Are federal fund cuts for poor performance such as for DSHS programs affecting the state budget or ability to fund priorities such as pension systems?

b-Would it be wise to factor these potential budget issues into assumptions regarding all of the pension plans?

10- What percentage of state pension funds are invested in the stock market versus property or other types of assets?

Thanks to the efforts of the State Actuary, and the support of the Select Committee on Pension Policy Washington State has enjoyed being rated by many as the third most actuarily sound program of all the states. Last month it was reported that has slipped to 6th or 7th place due to less than anticipated stock market experience of late. The market was about the only US institution which weathered the several years of recession. That was to a degree a false positive assumption due to the FEDS continual quantitative easing (printing new money by many Billions) and pouring it into banks and the market. That new money reduced the value of pensions by reducing the value of the dollar. It seems in light of some troubling signs in the economy the Legislature should continue to directly try to solve the TRS1 issues without creating another potential shortfall somewhere else in the pensions system.

The opportunity to ask questions and comment is appreciated.

Respectfully Submitted,

Jim Adsley

From:	Matt Albers
To:	Conway, Sen. Steve
Cc:	mwarbrouck@comcast.net; Office State Actuary, WA; Phil Talmadge
Subject:	Merger of LEOFF Plan 1/TRS 1 and LEOFF Plans 1 and 2 - Email 1 of 3
Date:	Monday, July 18, 2016 3:33:55 PM
Attachments:	Letter to Senator Conway 7.18.16.pdf Exhibit A.PDF Exhibit B.PDF Exhibit C Pt 1.pdf

Good afternoon:

Attached please find Philip A. Talmadge's letter regarding the Merger of LEOFF Plan 1/TRS 1 and LEOFF Plans 1 and 2. Due to the file size of the exhibits to this letter, I will email this letter and exhibits in three parts. This is email 1 of 3, containing the letter and Exhibits A, B and C, part 1. Please let me know if you have any trouble receiving any of these emails. Thank you.

Very truly yours,

Matt J. Albers, Paralegal
Talmadge/Fitzpatrick/Tribe PLLC
2775 Harbor Avenue SW
Third Floor, Suite C
Seattle, WA 98126
Phone: (206) 574-6661
E-mail: matt@tal-fitzlaw.com

TALMADGE
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TRIBE
2775 Harbor Ave. SW | 3rd Floor, Suite C | Seattle, WA 98126 | 206.574.6661 | 206.575.1397 Fax

VIA EMAIL AND U.S. MAIL

July 18, 2016

Senator Steve Conway
Chair, Select Committee on Pension Policy
P.O. Box 40429
Olympia, WA 98504-0429

Re: Merger of LEOFF Plan 1/TRS 1 and LEOFF Plans 1 and 2

Dear Sen. Conway:

I represent the Retired Firefighters of Washington ("RFFOW"). The Select Committee on Pension Policy ("SCPP") will be assessing the possible merger of LEOFF Plan 1/TRS 1 and LEOFF Plans 1 and 2 at its upcoming July 19, 2016 meeting. I am writing to re-emphasize RFFOW's opposition to either proposal.

As you know, proposals for pension system mergers, driven by the need to access easy sources of possible revenue, are common in the Legislature. Only this year, SB 6668 was introduced. That bill proposed to merge LEOFF Plan 1 and TRS 1. The proposal was ill-advised, generating widespread opposition in no small part based on serious legal concerns raised by RFFOW. *See* Ex. A. Moreover, that bill, never formally heard by any committee, bypassed any review by SCPP, another ill-advised effort. This bill did not pass.

Now, SCPP has been asked to review these merger issues. Neither merger makes policy or fiscal sense.

First, the benefits of any merger is predicated upon entirely rosy assumptions concerning the rates of return on pension system funds. Those rosy assumptions are not merited, as a recent Tacoma *News Tribune* editorial documented. Ex. B.

Moreover, like the legal issues surrounding a LEOFF Plan 1/TRS 1 merger, *many* legal questions surrounding a LEOFF Plan 1 and 2 merger that surfaced in 2011 and 2012 (and even before those merger efforts) remain just as pertinent now, meriting the SCPP's serious attention. Ex. C.

I do *want* to emphasize one aspect of any proposed merger – tax implications. These tax implications are alluded to in a letter dated October 5, 2011 by the A. Ice Miller firm. Ex. D. The IRS imposes numerous demands upon public pension systems that propose to merge. I believe it requires that a percentage of any "surplus" funds of the system targeted for merger be set aside and may not be immediately available to the new merged system. In any event, a very careful assessment by SCPP of the full range of tax issues associated with any merger is absolutely vital to protect the plan members and taxpayers alike.

Finally, as you may detect from the attached materials, the Attorney General's office and the LEOFF 2 Board received legal advice about the proposed merger of LEOFF Plans 1 and 2 in 2011 and 2012, and perhaps later. They chose not to disclose all of that advice publicly in 2011 and 2012. In the interest of transparency and to allow the SCPP to perform its duties appropriately, RFFOW urges you to obtain *all* of the pertinent legal opinions obtained by the AG or the Board from outside counsel pertinent to a merger of LEOFF Plans 1 and 2 and that the SCPP make such opinions public. If similar opinions from outside counsel were obtained by the AG on a merger of LEOFF Plan 1/TRS 1, RFFOW also asks that such opinions be made public.

Thank you for your consideration of the foregoing.

Very truly yours,

Phil Talmadge

Philip A. Talmadge

cc: Richard C. Warbrouck
Matthew Smith, State Actuary

EXHIBIT A

TALMADGE | FITZPATRICK TRIBE

2775 Harbor Ave. SW | 3rd Floor, Suite C | Seattle, WA 98126 | 206.574.6661 | 206.575.1397 Fax

February 29, 2016

TO: Dick Warbrouck
President of the Retired Firefighters of Washington

FROM: Phil Talmadge Phil

RE: SB 6668

Dick:

You asked me to consider the legal implications of this proposed legislation that merges the LEOFF Plan 1 fund with the Teachers Retirement System Plan 1 fund (sec. 2). The legislation would allow the Department of Retirement Systems ("DRS") to effectively apply the apparent surplus in LEOFF Plan 1 to the deficit in TRS Plan 1. However, the legislation would afford LEOFF Plan 1 members or their beneficiaries a one-time $5,000 payout (sec. 6), LEOFF Plan 1 members and employers would not contribute (for now) to the new merged fund (sec. 8(3)), the benefits of LEOFF Plan 1 members are not to be reduced (sec. 3(1)), and the responsibilities as to local disability boards are not affected (sec. 4).

This effort bears at least a resemblance to prior legislative efforts to merge LEOFF Plan 1 and 2. I enclose copies of 2011 and 2012 memos prepared for you in connection with those efforts. This legislation avoids some of the key problems with those earlier legislative efforts such as modification of the make-up of local disability boards.

The critical legal issue here is essentially whether LEOFF Plan 1 members have a contractual right to their contributions (and those of their employers) to the LEOFF fund plus accrued interest. If they do, the Legislature may not alter such a contractual right under *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (1956) to the disadvantage of LEOFF Plan 1 members, without providing them "comparable new advantages." *Id.* at 701-02. *See also, McAllister v. City of Bellevue Firemen's Pension Bd.*, 166 Wn.2d 623, 628, 210 P.3d 1002 (2009). A further question, of course, is whether $5000 represents a sufficient offset to any lost rights LEOFF Plan 1 members sustained in the proposed LEOFF Plan 1/TRS Plan 1 merger.

Our Supreme Court has determined that pension systems are not trust funds as to which beneficiaries have rights afforded under trust law, *Retired Public Employees Council of Wash. v. Charles*, 148 Wn.2d 602, 620-22, 62 P.3d 470 (2003), but the Court in that same case held that retirement plan members have a right to the systematic funding of a retirement system to maintain its actuarial soundness as a contract benefit that may not be altered by legislation. *Id.* at 625. Clearly, this means LEOFF Plan 1 members have a right to a sound plan to pay them *existing benefits*. But if a plan generates a surplus, do they then own the fund and a right to secure *added benefits* to be paid from the surplus?

If an actuarially-sound and properly funded pension system is a contractual right that cannot be modified by the Legislature without satisfying *Bakenhus*, it seems to me that contributions, at least by the member, plus interest accruing over the years on such contributions,[1] constitute a vital component of that financially sound pension system.

Our Supreme Court's most recent pension cases pertaining to future cost-of-living adjustments and "gain sharing" address this question of members' rights in connection with a pension fund. In *Wash. Educ. Ass'n v. Wash. Dep't of Ret. Sys.*, 181 Wn.2d 212, 332 P.3d 428 (2014), the Court held that members did not have a contractual right to gain-sharing, a legislative program that allowed members to receive a pension enhancement when rates of return on pension fund investments were favorable, because the Legislature reserved the right to amend or repeal such a benefit at the time it was enacted. As such it never became a member contract right, but was a matter of legislative grace and could be repealed. Similarly, in *Wash. Educ. Ass'n v. Wash. Dep't of Ret. Sys.*, 181 Wn.2d 233, 332 P.3d 429 (2014), the Court applied a similar analysis to conclude that the Legislature's repeal of certain COLA benefits adopted by statute were not contractual rights because the enacting legislation reserved to the Legislature the right to repeal or amend the benefits.

Here, there is no reservation of any legislative right to adjust *past* contributions and plan earnings once they took place. The contributions were made, interest was earned on their investment, and benefits were paid. The Legislature, of course, was and is free to adjust the contribution

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[1] The usual rule in property law is that interest follows principal. *Phillips v. Wash. Legal Found.*, 524 U.S. 156, 164-65, 118 S. Ct. 1925, 141 L. Ed. 2d 174 (1998). In other words, if the contributions belong to the pension system member, so does the interest accruing on such contributions.

rates to ensure that a pension fund is actuarially sound going forward, as the Legislature is, in fact, proposing to do in SB 6668.

Simply stated, the basic contract between LEOFF and its members was that LEOFF Plan 1 employees and employers would make contributions to that fund. Contributions would (hopefully) earn interest. Employees, on retirement, would be paid a defined benefit. The expectation was that contributions plus interest would approximate benefits paid out to LEOFF members. Where there is the fortuity of a surplus in the LEOFF Plan 1 fund, the funds there are for the members, perhaps for the payment of one-time (as in SB 6668), or longer term, added benefits, at the option of the Legislature. But in my view, that surplus is a contract right of LEOFF Plan 1 members that cannot be impaired by legislative action such as seizing it and giving to other pension system members such as teachers (and benefitting them by lowering their contribution rates, and those of their employers, to TRS Plan 1) to the detriment of LEOFF Plan 1 members.

This view is buttressed by my discussion in my LEOFF I/LEOFF II merger memoranda concerning the structure for the administration of benefits as a contract right. Just as the boards under RCW 41.26.150 are structurally-central to LEOFF Plan 1 pensions and constitute a contract right, the structure of pensions set forth above, in my view, are equally so.

Finally, on the issue of whether $5,000 is a sufficient offset to avoid impairment of contact under *Bakenhus* would require a careful examination of the present surplus in the LEOFF Plan 1 fund and the number of present beneficiaries. I have no opinion on that question at this point in the absence of further data.

Please let me know if you need more from me on this proposed bill.

KLAUSNER KAUFMAN JENSEN LEVINSON

A PARTNERSHIP OF PROFESSIONAL ASSOCIATIONS
ATTORNEYS AT LAW

Writer's Email: bob@robertdklausner.com

March 4, 2016

Dennis Lawson, President
Washington State Council of Fire Fighters
1069 Adams Street E.
Olympia, Washington 98501

Re: Senate Bill 6668
Our File No. 010031

Dear President Lawson:

This is in response to your request for comment on SB 6668 which merges the assets of the Law Enforcement Officers and Firefighters Plan 1 (LEOFF Plan 1) with the Teachers' Retirement System (TRS). For the reasons which follow, I believe the bill would pose substantial constitutional and "exclusive benefit" issues which may threaten the tax qualified status of the plans as well as the ultimate validity of the legislation.

As noted in their recent correspondence, the state's tax counsel, Ice Miller, advised that the legislation would be permissible as long as the exclusive benefit rule in the Tax Code was observed. The exclusive benefit rule, a requirement for favorable tax treatment of a pension plan, provides that the assets of a retirement plan may only be used for the benefit of the plan participants and to defer reasonable plan expenses. The assets may not inure to the benefit of the plan sponsor.

The bill, in our view, fails this test. Firstly, the purpose of the bill is to allow the assets of a fully funded plan (LEOFF 1) to offset the state's obligation to the less well funded TRS. The actuary's fiscal note shows a reduction in funding from the State to TRS in the amount of $319,200,000 over the next three years. Simply stated, the bill takes money reserved exclusively for LEOFF Plan 1 members and allows it substitute for state contributions to TRS Plan 1.

We have been advised that the combination of the LEOFF Plan assets into TRS would have the effect of making the new combined plan better funded and allow a reduction

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www.robertdklausner.com

of state contributions. To the extent that the beneficial use of these LEOFF Plan 1 assets is claimed as available to satisfy the TRS liability, the bill, at the very least, creates a false picture of the financial status of the TRS system and would conflict with accepted principles of governmental financial disclosure.

Washington law has long recognized the constitutional protection of retirement benefits. See generally, *Bakenhus v. City of Seattle*, 296 P.2d 536 (Wash. 1956). Reduction of required contributions is an impairment of contract if it can adversely affect the successful operation of the retirement system or lessen the value of the retirement benefits. See, *Retired Public Employees Council v. Charles*, 62 P.3d 470 (Wash. 2003)(rejecting challenge to lower contribution rates when it did not adversely affect the retirement system).

The lesson of the *Charles* case is that the use of plan assets and the timely transmission of the actuarially required contributions is an essential part of the constitutionally protected pension contract. This principle was also articulated by the Washington Supreme Court in *Weaver v. Evans*, 495 P.2d 639 (Wash. 1972). LEOFF Plan 1 is funded at 127% of assets to liabilities, according to the most recent actuarial valuation. This does not take into account at the present time the adverse effect of the market instability observed in recent months. A merged TRS / LEOFF Plan 1 system would have a funded ratio of no more than 88% according to the assets and liabilities published in the most recent actuarial valuations. This significantly reduced funded status which destabilizes the retirement security of LEOFF Plan 1 participants is directly contrary to the constitutional rights recognized in *Weaver*.

In the context of the pending legislation, a decision of the Supreme Court of Alaska concerning the merger of plan assets to reduce an actuarial liability offers a picture of the liability being created. In *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997), the court considered an Anchorage city ordinance merging the three tiers of the police and fire retirement system together for the purpose of eliminating additional city contributions. The city plan had three tiers based on date of hire. Tiers 1 and 2 had assets significantly in excess of liabilities but Tier 3 had an unfunded liability. The assets of the three tiers were always co-mingled for investment purposes and administered by a single board of trustees. The Alaska Supreme Court unanimously struck down the ordinance finding that the members of each tier have a vested right to the sole beneficial use of the assets of their respective tiers. See also, *Valdes v. Cory*, 189 Cal. Rptr. 212 (Cal. App. 1983)(suspension of contributions contrary to actuarial needs of a retirement plan impairs contract rights of participants). Similarly, in *Wisconsin Retired Teachers Ass'n. v. Employe Trust Funds Board*, 558 N.W.2d 83 (1997), the state supreme court invalidated an attempt to divert plan assets expressly reserved for one class of members to provide cost of living benefits for other plan members.

On the basis of the overwhelming weight of jurisprudence, it is our view that SB 6668 would violate Article I, Section 23 of the Washington Constitution. It will undoubtedly result in costly and protracted litigation with uncertain results that would cast considerable doubt on the retirement security of public safety officers and teachers alike as well as creating uncertainty in the state budgetary process.

Thank you for the opportunity to review this important proposed legislation.

Sincerely,

ROBERT D. KLAUSNER

RDK/yv

EXHIBIT B

THE NEWS TRIBUNE
http://www.thenewstribune.com/news/business/biz-columns-blogs/article86667072.html

JULY 2, 2016 11:51 AM

Funds managed by state investment board need closer look

BY GARY BROOKS
Contributing writer

A key part of any financial plan is determining the expected return of its investments. The return assumption is influential in determining the likelihood of funding the goals of the plan. Even under the clearest conditions the expected return is difficult to determine.

Many financial tools will evaluate an investment portfolio and present a projected return based on the historical performance of the underlying investments. While these tools can optimize portfolio construction for past conditions, the relevance of this number compared with future returns is at best, uncertain.

A globally balanced portfolio of 60 percent stocks and 40 percent bonds — generally a neutral allocation that is not aggressive or conservative — could easily present a projected average annual return of 7 percent to 8 percent based on historical precedent.

With income from bonds at historic lows (even negative in much of the world) and U.S. stocks seemingly expensive (even after the Brexit dip), I don't think it's an intellectually honest assessment to project 7 percent or 8 percent returns for anything short of an aggressively positioned portfolio.

This creates a bit of concern when I review the investment account that has the widest effect on Washington residents. The Washington State Investment Board manages funds to meet the retirement pension obligations for government employees (teachers, police, firefighters and other state workers). The largest pool of this money — a little over $80 billion as of March 31 reporting — is in the Retirement Commingled Trust Fund. This fund receives contributions from employees and employers but more significantly relies on investment returns to grow this pool of money significantly enough to meet future pension obligations. Current state law has set the return expectation for these funds at 7.8 percent per year over time. Next July 1, the return assumption will decline to 7.7 percent per year.

ELUSIVE TARGETS

For many years, this return didn't appear prohibitive. In fact, some similar investment pools around the country targeted meaningfully higher returns. Official return expectations have come down but may need to continue retreating to reflect reality. The realized 10-year average annual return for this Commingled Trust Fund ending March 31, 2016 was just 6.12 percent. And investment conditions don't appear to support higher returns any time soon.

News Tribune

I occasionally review projected returns for a variety of global asset classes from different firms. When applying these assumptions (which are usually targeted for the next seven to 10 years) to the state's Commingled Trust Fund investment mix, the result is a projected portfolio return of less than 6 percent, well under the 7.8 percent return that is currently planned for.

This state portfolio has a target asset mix of 37 percent public stocks (U.S. and international liquid stocks traded on public exchanges), 23 percent private equity (several types of investments only available to certain sophisticated investors in closed markets), 20 percent fixed income (publicly traded bonds from governments and corporations), 15 percent real estate (commercial properties around the globe, mostly privately traded) and 5 percent tangible assets (real assets such as commodities).

HEAVY LIFTING REQUIRED

Given this allocation, it's clear that the state investment board expects the illiquid investments in private equity and real estate to do a lot of heavy lifting to generate returns above the broad portfolio target of 7.8 percent on an annual average basis. These excess returns will likely be needed to offset lower forward returns from bonds. The bond market landscape of today may be challenged to contribute 3 percent annual returns over the next decade. This may require private equity to exceed its 10-year return in the state pool of 9.6 percent to offset the reduced contribution from bonds.

The state investment board is not alone in expecting excess returns from private equity investments. It is a common asset class in institutional portfolios. The state also is not alone in its 7.8 percent return target. Of 127 state pension plans evaluated by the National Association of State Retirement Administrators, 44 of them have expected average annual returns at 7.8 percent or higher.

IMPLICATIONS OF SHORTFALL

Even a 0.5 percent difference in average annual investment returns would be massive over time. In just 10 years, if the $80 billion state pool earned a 7.3 percent annual return instead of 7.8 percent, the account balance would be over $6 billion less.

This sort of shortfall could eventually require employees to contribute more, or accept less retirement income in the future, to make up the difference. It is a significant challenge for any entity that accepts the investment risk of addressing huge pension liabilities. Even if actuaries suggest the plan is well-funded today, continued returns well short of the target may put stress on the ability to meet future obligations.

Gary Brooks is a certified financial planner and the president of Brooks, Hughes & Jones, a registered investment adviser in Gig Harbor.

Read more here: http://www.thenewstribune.com/news/business/biz-columns-blogs/article86667072.html#storylink=cpy

EXHIBIT C

Memorandum

TO:	Dick Warbrouck
FROM:	Phil Talmadge
DATE:	May 2, 2011
RE:	House Bill 2097

Dick:

I had an opportunity to review House Bill 2097, although I have not yet engaged in detailed legal research regarding its contents.

On the surface, the bill accomplishes two large changes in present law. First, the bill eliminates the Law Enforcement and Firefighters retirement system ("LEOFF") Plan I and merges it into a single LEOFF system. The unified LEOFF system is managed by a single state-wide board, as described in Section 6 of HB 2097. Similarly, the two separate LEOFF Plan I and Plan II retirement funds are combined into a single fund. Section 4(1).

Second, the legislation restores employee, employer, and state contributions to LEOFF. Section 1 of the bill restores contributions by LEOFF Plan II members and employers in the 2011-13 biennium. Contributions by Plan I employers and employees are restored effective July 1, 2013 and the rates of such contributions will be set by the new unified LEOFF board. Section 3(2).

From my cursory review of HB 2097, there are several very interesting implications of the bill. First, the bill's intent is plainly fiscal. LEOFF Plan I is presently running a small surplus. That surplus will exist probably through the end of the 2011-2013 biennium, according to State Actuary Matt Smith's Preliminary Risk Analysis dated April 18, 2011. That surplus becomes available to allow the Legislature to diminish general fund contributions to LEOFF Plan II. The revenues from the new contributions by Plan II members, employers, and the State (sec. 1 of HB 2097) and the LEOFF Plan I surplus will allow the Legislature to reduce general fund appropriations to LEOFF in the 2011-13 biennium. The Plan II contribution rates, particularly the State's, will be lower than otherwise required because of the seizure of the Plan I surplus. Ironically, for the future, the Actuary indicates that LEOFF Plan I will start to run a deficit. If that assessment is true, the combination of LEOFF Plan I and LEOFF Plan II will not benefit biennial budgets after 2013.

Second, left unaddressed in this legislation is the question of how the new unified LEOFF board will interact with local LEOFF Plan I boards. The legislation does not specifically repeal the statutory authority of local LEOFF boards. As you know, those local LEOFF boards have authority to award additional medical benefits for LEOFF Plan I retirees. Those local LEOFF boards have historically authorized such additional benefits as dental, vision, and even the payment of Medicare contributions for LEOFF Plan I retirees. If the intent of the Legislature is to eliminate the authority of local boards to act and to place control of the LEOFF in the new unified LEOFF board, there is an important question as to whether these benefits will persist or whether the unified LEOFF board will eliminate them. Plainly, if the LEOFF system generally has financial difficulties, there is a major incentive for the new unified board, consisting virtually entirely of LEOFF Plan II members, to eliminate benefits for the older retirees of LEOFF Plan I to hold down costs and to keep contributions by LEOFF Plan II members lower and retain the maximum benefits for LEOFF Plan II members. This raises an interesting question under *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (1956), which treats pensions as contracts and severely curtails the ability of the Legislature as a matter of constitutional law to impair them. Many LEOFF Plan I members, as you know, argue that the board structure itself is a benefit that has become, in effect, a contractual right of the LEOFF Plan I members. Would the potential elimination of these locally-authorized benefits constitute an impairment of the contractual agreement under which the LEOFF Plan I retirees retired?

Finally, the elimination of the LEOFF Plan I board and the creation of a unified LEOFF board is an important issue in HB 2097. The new unified LEOFF board contains a disproportionate number of LEOFF Plan II members to LEOFF Plan I members. It is highly likely that the board would be disposed to increase rates significantly for LEOFF Plan I members and diminish benefits that those members have. This is something of a due process/"taxation without representation" question. This is particularly important where the Legislature has delegated rate-setting authority to an unelected board. Arguably, the creation of a state wide board that control over LEOFF Plan I retirees and actives could impair the contractual agreement with LEOFF Plan I members, again invoking *Bakenhus* concerns.

If you require further analysis from me in connection with the provisions of HB 2097, please do not hesitate to let me know. I hope this quick analysis is helpful as you engage in further discussion with legislators and legislative staff regarding the ramifications of HB 2097.

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June 21, 2011

TO: Dick Warbrouck
President of the Retired Firefighters of Washington

Jerry Taylor
President of Retired Seattle Police Officers' Association

FROM: Phil Talmadge

RE: Legal Issues Surrounding the Possible Merger of LEOFF Plan I and II

Dick and Jerry:

I previously sent you a short email regarding possible legal issues associated with House Bill 2097, a bill introduced late in the 2011 legislative session to provide for the merger of LEOFF Plan I and II. You asked me to provide a more comprehensive legal analysis of the legal issues surrounding the possible merger of LEOFF Plan I and II. This legal analysis follows:

(1) Background to the Governance of LEOFF Plan I and II

As you know, there were several statutory pension systems in Washington for uniformed personnel prior to creation of the Law Enforcement Officers and Firefighters pension system ("LEOFF"). For example, for firefighters, a 1947 (RCW 41.16) and a 1955 pension system (RCW 41.18) governed the pension and disability entitlement of firefighters. Similarly, RCW 41.20 governed police officers in first class cities. Generally under those systems, decisions with respect to pension eligibility and disability were handled by local boards in the jurisdictions employing the firefighters and police officers. The 1969 Legislature established LEOFF. LEOFF contained components of both a retirement and disability system. Although under RCW 41.26.030(4), any then-existing firefighters or police officers became LEOFF members, new firefighters and police officers had to meet medical standards to be eligible for LEOFF membership. Under RCW 41.26.040(2), LEOFF firefighters and police officers were essentially entitled to any benefits that had been afforded such firefighters and police officers under the predecessor retirement systems. RCW 41.26.110 provided that the existing local disability boards would administer the new LEOFF I system, subject to rules established by the Department of Retirement Systems. RCW

41.26.115. If a firefighter or police officer was aggrieved by any decision of the local board on disability or retirement, he/she had a right of appeal to the director of the Department of Retirement Systems. RCW 41.26.200. Most critically, RCW 41.26.150 provided that LEOFF Plan I firefighters and police officers, both retirees and actives, had a right to certain medical benefits set forth in RCW 41.26.030(22). *Knudson v. City of Ellensburg*, 832 F.2d 1142 (9th Cir. 1997) (medical benefits are not contingent upon employment; retirees had the right to receive medical benefits under this statutory provision). But RCW 41.26.150 also provided that a local disability board had the discretionary authority to provide additional medical benefits beyond those set forth in RCW 41.26.030(22). *See Stegmeier v. City of Everett*, 21 Wn. App. 290, 584 P.2d 488 (1978) (court upholds board decision to allow retired police officer prescription eye glasses); *Snohomish Cy. Fire Dist. No. 1 v. Snohomish Cy.*, 128 Wn. App. 418, 425-26, 115 P.3d 1057 (2005) (court upholds authority of local board to reimburse certain dental expenses).

In 1977, the Legislature created LEOFF Plan II. It is generally acknowledged that LEOFF Plan II is not as generous in its benefits as is LEOFF Plan I. LEOFF Plan II does not afford its members the medical benefits allowed in LEOFF Plan I, for example. Issues relating to disability on the job are not addressed by LEOFF Plan II but rather under Washington's Industrial Insurance Act, Title 51 RCW. Police and firefighter groups proposed Initiative 790 to the voters in November, 2002 to address governance of LEOFF Plan II. The voters approved that measure which created a board of trustees for LEOFF Plan II that was separate and distinct from any legislative committees that had governed pension system previously. *See* RCW 41.26.700, et. seq. That board ostensibly has the authority to set contribution rates for employers, employees, and the State of Washington. RCW 41.26.705(5). *Retired Public Employees Council of Washington v. Charles*, 148 Wn.2d 602, 62 P.3d 470 (2003) (upholding the authority of the Legislature to set pension system contribution rates in a budget bill).

HB 2097 was introduced in the 2011 session of the Legislature. The bill proposed to merge the LEOFF Plan I and II funds. The bill also subjected the merged fund to the management of what was formerly LEOFF Plan II Board created by RCW 41.26.700 et. seq. The new merged board would set contribution rates for both LEOFF Plan I and II members and employers. The bill, however, did not specify whether the new combined board would have any responsibility in connection with supervision of the local disability boards' decisionmaking generally, or with respect to medical benefits under RCW 41.26.150 specifically. The Board's membership, now consisting of a majority of LEOFF Plan II members and retirees, was unaltered, except that the retiree member could be LEOFF Plan I or II. The bill retained the existing provisions of

RCW 41.26.715 which provided for 3 active firefighters and 3 active police officers. But in actual practice, with the diminishing number of LEOFF Plan I actives, members are likely to be Plan II. The bill did not pass the 2011 Legislature, but a study was authorized by the Legislature in the budget bill regarding possible merger of the two pension systems.

(2) Legal Issues

In considering the possible merger of LEOFF Plan I and II, a number of legal issues are present. This memorandum by no means considers all of the potential legal issues. However, four legal issues are readily apparent from any proposed merger, including:

(a) Under the decision of the Washington Supreme Court in *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956), are the independent LEOFF I and II funds a contractual benefit of LEOFF members that may not be disturbed under that decision?

(b) Is the local board process of LEOFF Plan I in which local boards make disability and retirement decision and can authorize added medical benefits under RCW 41.26.150, a contractual right of LEOFF Plan I members that cannot be disturbed under *Bakenhus*?

(c) Where the Legislature is excluded from any role in the setting of contribution rates for Plan I and II members, notwithstanding the provisions of Initiative 790 as set forth in RCW 41.26.700 et. seq., do such contribution rates require legislative approval under Initiative 1053 or Article VII, § 5 of the Washington Constitution?

(d) Does the makeup of a combined LEOFF board with its disproportionate (or even an exclusive) number of LEOFF II members violate the rights of LEOFF I members whose pension rights are decided by such a board?

(3) *Bakenhus*-Related Questions

In order to answer questions (a) and (b) above, it is important to understand the rule articulated in *Bakenhus.* In numerous appellate court decisions and AGOs,[1] our Supreme Court addressed the question of legitimacy of changes to laws governing a pension system both for current members or

[1] I have generally chosen not to cite the numerous AGOs on pension issues generally and LEOFF issues specifically unless they bear directly on the legal issue discussed herein.

retirees. In general terms, the right to a public pension commences upon the first day of employee's employment and continues to vest with each day of service thereafter. *Tembruell v. City of Seattle*, 64 Wn.2d 503, 506, 392 P.2d 453 (1964). That employee's pension entitlement, based on contract, is in accord with the statutes as they existed when the employee began his/her service. *Mulholland v. City of Tacoma,* 83 Wn.2d 782, 785-86, 522 P.2d 1157 (1974); *Noah v. State*, 112 Wn.2d 841, 845 n.1, 774 P.2d 516 (1989).

Bakenhus, a retired Seattle police officer, sued Seattle, challenging a policy which set a maximum of $125 per month on police pensions. When he commenced his employment with Seattle in 1925, he was entitled to receive one-half of the salary he had received during the last year before his retirement. Bakenhus obtained a judgment directing that he be paid a pension of one-half of his last month's salary and a judgment for the difference between the pension he had been paid from the date of his retirement and the amount he should have received. Our Supreme Court started from the premise that a pension granted to a public employee is not a gratuity but is deferred compensation for services rendered on a contractual basis. *Id.* at 700. Thus, when an employee accepts a job to which a pension plan is applicable, that employee contracts for the pension and is entitled that pension when he/she has fulfilled all of the conditions associated with it. The Court indicated that pension rights may be modified prior to the employee's retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity. 48 Wn.2d at 701. More specifically, citing California authority, our Supreme Court stated that any such modifications to the pension system "must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." *Id.* at 701-02.[2] The Court sustained Bakenhus' rights under the pension system that applied when he began working for Seattle.

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[2] The Supreme Court in *Dailey v. City of Seattle,* 54 Wn.2d 733, 344 P.2d 718 (1959) summarized its holding in *Bakenhus* as follows: "1. That employees who accept employment to which pension plans are applicable contract thereby for a substantial pension, and are entitled to receive the same when they have fulfilled the prescribed conditions. 2. That employees (perspective pensioners) will be presumed to have acquiesced in legislative modifications that do not unreasonably reduce or impair existing pension rights; or, stated positively, if the modifications are reasonable and equitable. 3. That an act of the Legislature, making a change in pension rights, will be weighed against pre-existing rights in each individual case to determine whether it is reasonable and equitable. If the over-all result is reasonable and equitable, the employees (prospective pensioners) will be presumed to have acquiesced in the modification; if the over-all result is not reasonable and equitable, there will be no such presumption." *Id.* at 738-39.

In cases subsequent to *Bakenhus,* our Supreme Court rooted its analysis in Article I, § 23 of the Washington Constitution which precludes legislation impairing the obligations of contract. In a recent case addressing the *Bakenhus* rule, our Supreme Court in *McAllister v. City of Bellevue Firemen's Pension Board,* 166 Wn.2d 623, 628, 210 P.3d 1002 (2009) reaffirmed the *Bakenhus* rule that any changes to a pension system could not result in disadvantage to the employee over the employee's former pension plan.

RCW 41.26.040(2) codifies *Bakenhus,* guaranteeing that a firefighter retiring or police officer under LEOFF must not suffer any diminution in benefits that would have available if LEOFF had not been enacted. *McAllister,* 166 Wn.2d at 629.

Washington courts have broadly construed the scope of these contractual rights; they are not confined to pensions alone. For example, service-connected disability rights of a police officer fall within *Bakenhus. State ex rel. Johnson v. Funkhouser,* 52 Wn.2d 370, 325 P.2d 297 (1958). *See also, Eisenbacher v. City of Tacoma,* 53 Wn.2d 280, 333 P.2d 642 (1958) (*Bakenhus* not confined to retirement for service pension rights in case of firefighter where pension system covered service/nonservice disability and retirement). *Bakenhus* principles also apply to pension-related benefits negotiated in a collective bargaining agreement between a private employer and employees, *Dorward v. ILWU-PMA Pension Plan,* 75 Wn.2d 478, 452 P.2d 258 (1969), or a public employer and employees, *Internat'l Ass'n of Firefighters, Local 1789 v. Spokane Airports,* 146 Wn.2d 207, 45 P.3d 186 (2002) (airport fire service employees voluntarily agreed to pay Social Security and Medicare, matched by employer contributions; when union opted out of Social Security/Medicare, employer refused to return the employer match for both systems to the employees; Social Security/Medicare contributions fall within *Bakenhus).*

Washington courts have held that a variety of rights, including rights that indirectly affect a pension, are contractual in nature and are not subject to change by Legislature to the disadvantage of the employee or retiree. *See, e.g., Bakenhus, supra* (size of a pension); *Weaver v. Evans,* 80 Wn.2d 461, 495 P.2d 639 (1972) (systemic funding of pension system); *Washington Association of County Officials v. Washington Public Employees Retirement System Board,* 89 Wn.2d 729, 733, 575 P.2d 230 (1978) (right to a practice of including certain lump sum payments in the calculation of retirement benefits); *Eagan v. Spellman,* 90 Wn.2d 248, 258, 581 P.2d 1038 (1978) (right to a statutory retirement age at the time of employment); *Horowitz v. Dep't of Retirement Systems,* 96 Wn.2d 468, 635 P.2d 1078 (1981) (rights to refund of pension contributions); *Washington Federation of State Employees v. State,* 98 Wn.2d 677, 679, 658 P.2d 634 (1983) (the right to add to a pension by using accrued vacation pay).

By contrast, the mortality tables for calculating annuity benefits, *King County Employees' Ass'n v. State Employees Retirement Board*, 54 Wn.2d 1, 336 P.2d 387 (1959), or contribution rates, *Charles, supra* are not contractual benefits.

With respect to the first of the two legal questions above, it appears that an aspect of that question has been answered by decisional law. In *Charles, supra*, the Supreme Court held that the right to the systematic funding of a retirement system to maintain its actuarial soundness is a contractual benefit that may not be altered by legislation. 148 Wn.2d at 625. Thus, LEOFF Plan I members are entitled to an actuarially sound and appropriately funded pension system. To the extent that merger of Plan I and Plan II funds would undercut the actuarial soundness of LEOFF Plan I or impact the appropriate funding of LEOFF Plan I, a merger would violate the *Bakenhus*.

With respect to the second of the two questions, as to medical benefits, the question of whether medical benefits are a contractual right under LEOFF Plan I has not been specifically tested in court. However, in *Navlet v. Port of Seattle*, 164 Wn.2d 818, 194 P.3d 212 (2008), the Supreme Court held that certain lifetime retirement health care and welfare benefits provided pursuant to a collective bargaining agreement between the port and a union which guaranteed the employees who reached retirement the same level of medical and welfare coverage they had received during active employment constituted a vested right under *Bakenhus* that could not be altered.

In AGLO 1975 No. 2, 1975 WL 165841 (1975), the Attorney General specifically concluded that the provisions of RCW 41.26.150 are contractual rights subject to *Bakenhus*. The Attorney General there rejected the contention that benefits under RCW 41.26.150 were not a contractual right of LEOFF Plan I members, noting that such benefits were plainly a part of LEOFF pension system and they were governed by *Bakenhus*.

Thus, in my opinion, the medical benefits of RCW 41.26.150, including the discretionary ability of local disability boards to authorize additional medical benefits for retirees subject to their jurisdiction, constitute vested contractual rights that may not be altered under *Bakenhus*.

(4) Authority of Merged Board to Set Contribution Rates

While RCW 41.26.705(5) purports to confer exclusive authority upon the LEOFF Plan II Board to set contribution rates for LEOFF Plan II members, and the new board would have been given the authority to set contribution rates for

LEOFF Plan I members under HB 2097, that authority is circumscribed by the provisions of RCW 43.135.055.[3]

Over the course of the last decade, super majority requirements for the enactment of fees and taxes have been imposed by initiative. Most recently, in November 2010, Initiative 1053 was adopted by the voters. It establishes a 2/3 super majority requirement for the enactment of taxes in RCW 43.135.034. Moreover, RCW 43.135.055 addresses fees and states:

> A fee may only be imposed or increased in any fiscal year if approved with majority legislative approval in both the House of Representatives and the Senate and must be subject to the accountability procedures required by RCW 43.135.031.

RCW 43.135.055(1). RCW 43.135.005, the initiative's intent section, makes clear that there must be legislative approval for any fee increase. Section 9 of Initiative 1053 specifically provides that the initiative is to "be liberally construed to effectuate the intent, policies, and purposes of this act."

No definition is set forth in RCW 43.135 for a "fee."[4] *Merriam-Webster's Collegiate Dictionary* (11th ed.) defines a fee as "a fixed charge" or "a sum paid or charged for a service." In addition to RCW 43.135.055, other statutes narrow the fee-setting authority of the Legislature. For example, RCW 82.02.020 limits the authority of local jurisdictions to land use-related impose fees. That statute offers an analogous definition of a "fee" and our courts have broadly construed a "fee" under that statute. For example, in cases arising under RCW 82.02.020, fees, charges, even indirect assessments fall within the scope of the statutory provision. *Isla Verde International Holdings, Inc. v. City of Camas*, 146 Wn.2d 740, 757-58, 39 P.3d 867 (2002); *Citizens for Rational Shoreline Planning*, 155

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[3] Article VII, § 5 of the Washington Constitution also provides that taxes may only be imposed "in pursuance of law." Under this constitutional provision, a tax must be expressly imposed by statute or local ordinance. *Okeson v. City of Seattle*, 150 Wn.2d 540, 556, 78 P.3d 1279 (2003). But to the extent that the pension contribution rates do not constitute a tax, but rather are a fee, Article VII, § 5 of the Washington Constitution does not apply. *State v. Sheppard*, 79 Wash. 328, 140 Pac. 332 (1914).

[4] The legality of a decision by the Legislature to lower the statutorily-set contribution rates for pension systems was tested in *Charles*. There, the Supreme Court determined that pension system members had standing to challenge the rate issue and in so doing determined that a pension system is not a trust. Rather, a pension system is a creature of statute. The Court further concluded that the contribution rates were not a contractual right under *Bakenhus* in the absence of specific proof that the lower contribution rates would prevent the effective operation of the pension system, rendering it actuarially unsound. 148 Wn.2d at 625-28.

Wn. App. 937, 942-43, 230 P.3d 1074, *review granted*, 170 Wn.2d 1001 (2010).

The most often litigated question is whether a particular assessment is a fee or a tax. For example, *Covell v. City of Seattle*, 127 Wn.2d 874, 879, 905 P.2d 324 (1995) distinguishes between a tax and a fee. If an assessment is a tax, it may be subject to constitutional limitations. Beginning in *Covell*, the Supreme Court articulated a three-part test to distinguish a fee from a tax; that test looks (1) to whether the purpose of revenue enhancer is to regulate or raise revenue; (2) whether the funds generated are dedicated to a regulatory purpose; and (3) if there is a direct relationship between the assessment and the service received burden created by the payor. There, the Court held that Seattle's residential street utility charge was a tax not a fee. Our Supreme Court and the Court of Appeals have adhered to the three-part test in many subsequent decisions.

In my opinion, under that test, the contribution rates do not constitute taxes, but rather are fees. Assessments for purposes that do not involve public revenue have generally been seen by our courts not to be taxes. *State ex rel. Davis-Smith v. Clausen*, 65 Wash. 156, 203, 117 Pac. 1101 (1911) (worker compensation premiums); *Aetna Life Ins. Co. v. Wash. Life & Disability Ins. Guaranty Ass'n*, 83 Wn.2d 523, 538, 520 P.2d 162 (1974) (insurance guaranty assessments for fund to pay claims for liquidated insurers). Further, given the broad judicial interpretation of fees in statutes like RCW 82.02.020, I believe it is likely a Court would deem LEOFF contribution rates to be fees. As such they fall within the scope of RCW 43.135.055.

Finally, if the contributions are fees, can the Board impose them without legislative involvement? I do not believe so. The general principle for interpreting statutes adopted by Washington courts is that the most recent and more specific enactment covering a particular issue governs. *Muije v. Dep't of Social & Health Servs.*, 97 Wn.2d 451, 453, 645 P.2d 1086 (1982) (provisions of a specific statute passed subsequent to a general statute will prevail); *Citizens for Clean Air v. City of Spokane*, 114 Wn.2d 20, 37, 785 P.2d 447 (1990). Here, I-1053 is the more recent and specific statute on the issue of legislative approval of fees. Thus, in my opinion, the authority of a combined LEOFF Board to impose contribution rates is subject to RCW 43.135.055. The Legislature, not the Board, must establish the contribution rates for LEOFF retirees insofar as contribution rates constitute a fee.

(5) Due Process Issues Associated with Management of Merged LEOFF Fund

LEOFF Plan I is presently managed by the Department of Retirement Systems. RCW 41.50.055. Contributions to that fund are governed by statute. RCW 41.26.080. The liabilities of the LEOFF Plan I system must be funded in accordance with the provisions of RCW 41.45. By contrast, the LEOFF Plan II Board manages LEOFF Plan II fund, RCW 41.26.720(1), although it must work cooperatively with the State Investment Board in doing so. RCW 41.26.732. The LEOFF Board is made up of eleven members, six of whom are active or retired LEOFF II members.

Under the provisions of HB 2097, the merged Board would still very likely have a majority of LEOFF Plan II members, with little representation for LEOFF Plan I members, even though that Board would set LEOFF Plan I contribution rates and would manage the retirement funds of the LEOFF Plan I members.

Washington courts have historically expressed the view that "taxation without representation" violates fundamental constitutional principles relating to voting or due process. Here, of course, no "taxation" is at issue, but the imposition of contribution rates and management of the LEOFF Plan I funds substantially impact LEOFF Plan I members, entitling them to fair representation on the unelected board making such decisions, particularly were a court to disagree with my opinion that the contribution rates must be set by the Legislature under RCW 43.135.055.

In *Malim v. Bethiem,* 114 Wash. 533, 196 Pac. 7 (1921), our Supreme Court held that a statute purporting to allow a diking district to assess lands outside the district's boundaries where those landowners had no right to vote in district elections was unconstitutional as it deprived the landowners of the right to free and fair elections under article I, § 19 of the Washington Constitution. *See also, Foster v. Sunnyside Valley Irr. Distr.*, 102 Wn.2d 395, 687 P.2d 841 (1984) (invalidating irrigation district voting statute limiting vote to agricultural land owners).[5] Similarly, in *State ex rel. Tax Commission v. Redd*, 166 Wash. 132, 6 P.2d 619 (1932), the Court overturned an effort by the State Tax Commission to reassess certain property in Franklin County for local tax purposes. The Court held that the Legislature could not take from the people of that county the right to locally assess their property, an action the Court deemed

[5] Where the governmental body has general governmental powers, equal protection principles dictate that "one-person, one-vote" must govern. *Cunningham v. Municipality of Metro. Seattle*, 751 F. Supp. 885 (W. D. Wash. 1990) (invalidating make-up of Metro Council made up of mixture of elected and appointed officials on one-person, one-vote grounds). The LEOFF's Board's authority is arguably more narrow than "general government" purposes.

central to their "right of local-self-government secured to them by our Constitution." *Id.* at 139.

In recent cases, however, our Supreme Court has indicated that there is no need for direct representation for affected constituencies on a governmental board if the board is made up of elected officials. In *Granite Falls Library Capital Facilities Area v. Taxpayers of Granite Falls Library Capital Facilities Area*, 134 Wn.2d 825, 953 P.2d 1150 (1998), the library capital facilities area was a distinct quasi-municipal corporation that could levy taxes; its governing body was made up solely of three elected county council members. The Court rejected a challenge to the board's makeup on article I, § 19, due process, and equal protection grounds where the voters of the facilities area expressly approved the sale of bonds by the area and the power of the board to levy taxes to pay for the bonds. The Court did not offer a detailed analysis for its conclusion, but it appears that the delegation of taxing power to this board was proper so long as procedural safeguards like the right to vote on the taxing authority constrained the board's actions. *Id.* at 842, 844. *See also, Municipality of Metro Seattle v. City of Seattle*, 57 Wn.2d 446, 454, 357 P.2d 863 (1960) (Metro Council could levy taxes because the Council, though appointed, consisted of elected officials in the region); *Larson v. Seattle Popular Monorail Authority*, 156 Wn.2d 752, 131 P.3d 892 (2006) (Court upholds authority of Monorail board to levy taxes where board was created by voters and consisted of both elected and appointed members); Mathew Senechal, *Revisiting Granite Falls: Why the Seattle Monorail Project Requires Re-Examination of Washington Prohibition on Taxation Without Representation*, 29 Seattle U. L. Rev. 63 (2005).

In sum, in my opinion, no Washington case has authorized the delegation of a significant fiscal power such as the power to tax or impose fees, or to manage hundreds of millions of dollars in pension funds to an unelected board whose make-up is largely devoid of persons selected by, or representative of, the persons affected by the board's decision. A board that has power over vital financial interests of LEOFF Plan I members, that entirely, or even largely, consists of LEOFF Plan II members, whose interests may diverge from those of the LEOFF Plan I members, violates constitutional principles.

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February 1, 2012

TO: Dick Warbrouck
President of the Retired Firefighters of Washington

Jerry Taylor
President of Retired Seattle Police Officers' Association

FROM: Phil Talmadge

RE: HB 2350/SB 6563 – Proposed LEOFF Plan I and II Merger

Dick and Jerry:

I previously gave you my thoughts on possible legal issues associated with House Bill 2097, a bill introduced late in the 2011 legislative session, that proposed the merger of LEOFF Plan I and II. HB 2097 died in committee.[1] However, a study group was created after the 2011 session to consider merger. In theory, the group involved all "stakeholders" associated with the merger. In practice, the group was bent on *promoting* merger and was not receptive to providing information to LEOFF Plan I advocates.

At the behest of LEOFF Plan II Board ("Board") chair Kelly Fox and its director Steve Nelsen, attorney Robert Klausner and the Ice Miller law firm were retained to provide legal opinions to the Board on tax implications and other legal questions associated with merger. Despite *repeated* requests to the Board and PRA requests, only a letter from Ice Miller and nothing from Klausner was made public. It is not clear if the Ice Miller letter is the full scope of its opinion on merger issues, nor is it clear any legal opinions have been provided to all Board members or legislators, depriving them of all necessary information, paid for by the taxpayers, on the merger issue.[2]

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[1] It is noteworthy that on page 5 of the Actuary's fiscal note for HB 2097 that he opined that LEOFF Plan I would have a surplus that would be used to lower contribution rates for LEOFF Plan II members. He also assumed (p. 6) that the new board would not recommend any further improvements in LEOFF Plan I benefits.

[2] I offer no opinion here on the viability of an action under the PRA to compel the Board to turn over the Klausner and Ice Miller opinions. But it is bad policy for the Board or legislators to consider merger without full appreciation of any legal risks or tax consequences from the IRS attendant upon any merger.

Without authorization from the Board, Fox and Nelsen have advocated for merger. As president of the Washington State Council of Firefighters, Fox's membership, who are principally LEOFF Plan II members, will benefit from a merger bill.[3]

For the 2012 legislative session, Representative Sullivan introduced HB 2350. SB 6365 has been introduced in the Senate. It is essentially the same bill as HB 2097, except that the bill could allow the Legislature to avoid making some $80 million in LEOFF Plan II contributions instead of the $15 million allowed by HB 2097.

The LEOFF Plan II Board recently voted 5-4 not to endorse HB 2350, but has since reversed itself.

You have received an excellent opinion on the workings of HB 2350 from attorney Joseph Fishnaller that I will not replicate. This legal analysis follows:

(1) Background to the Governance of LEOFF Plan I and II

As you know, there were several statutory pension systems in Washington for uniformed personnel prior to creation of the Law Enforcement Officers and Firefighters pension system ("LEOFF"). For example, for firefighters, a 1947 (RCW 41.16) and a 1955 pension system (RCW 41.18) governed the pension and disability entitlement of firefighters. Similarly, RCW 41.20 governed police officers in first class cities. Generally under those systems, decisions with respect to pension eligibility and disability were handled by local boards in the jurisdictions employing the firefighters and police officers. The 1969 Legislature established LEOFF. LEOFF contained components of both a retirement and

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[3] Mr. Fox's participation in the crafting of HB 2350/SB 6563 and his advocacy for the merger of LEOFF Plan I and II funds, particularly without Board authorization, may violate RCW 42.52.020 which states:

> No officer or state employee may have an interest, financial or otherwise, direct or indirect, or engage in a business or transaction or professional activity, or incur an obligation of any nature, that is in conflict with the proper discharge of the sate officer's or state employee's official duties.

Mr. Fox, as board chair, is a "state officer." RCW 42.52.010(19). His position with the State Council is a professional activity that may be in conflict with his duties as Board chair. He cannot use his position as Board chair to advance the interests of the people he represents outside of his service to the State. If HB 2350 or SB 6563 were enacted, the people Mr. Fox represents as president of the State Council would enjoy the benefit of diminished pension contributions.

disability system. Although under RCW 41.26.030(4), any then-existing firefighters or police officers became LEOFF members, new firefighters and police officers had to meet medical standards to be eligible for LEOFF membership. Under RCW 41.26.040(2), LEOFF firefighters and police officers were essentially entitled to any benefits that had been afforded such firefighters and police officers under the predecessor retirement systems. RCW 41.26.110 provided that the existing local disability boards would administer the new LEOFF I system, subject to rules established by the Department of Retirement Systems. RCW 41.26.115. If a firefighter or police officer was aggrieved by any decision of the local board on disability or retirement, he/she had a right of appeal to the director of the Department of Retirement Systems. RCW 41.26.200. Most critically, RCW 41.26.150 provided that LEOFF Plan I firefighters and police officers, both retirees and actives, had a right to certain medical benefits set forth in RCW 41.26.030(22). *Knudson v. City of Ellensburg*, 832 F.2d 1142 (9th Cir. 1997) (medical benefits are not contingent upon employment; retirees had the right to receive medical benefits under this statutory provision). But RCW 41.26.150 also provided that a local disability board had the discretionary authority to provide additional medical benefits beyond those set forth in RCW 41.26.030(22). *See Stegmeier v. City of Everett*, 21 Wn. App. 290, 584 P.2d 488 (1978) (court upholds board decision to allow retired police officer prescription eye glasses); *Snohomish Cy. Fire Dist. No. 1 v. Snohomish Cy.*, 128 Wn. App. 418, 425-26, 115 P.3d 1057 (2005) (court upholds authority of local board to reimburse certain dental expenses).

In 1977, the Legislature created LEOFF Plan II. It is generally acknowledged that LEOFF Plan II is not as generous in its benefits as is LEOFF Plan I. LEOFF Plan II does not afford its members the medical benefits allowed in LEOFF Plan I, for example. Issues relating to disability on the job are not addressed by LEOFF Plan II but rather under Washington's Industrial Insurance Act, Title 51 RCW. Police and firefighter groups proposed Initiative 790 to the voters in November, 2002 to address governance of LEOFF Plan II. The voters approved that measure which created a board of trustees for LEOFF Plan II that was separate and distinct from any legislative committees that had governed pension system previously. *See* RCW 41.26.700, et. seq. That board ostensibly has the authority to set contribution rates for employers, employees, and the State of Washington. RCW 41.26.705(5). *Retired Public Employees Council of Washington v. Charles*, 148 Wn.2d 602, 62 P.3d 470 (2003) (upholding the authority of the Legislature to set pension system contribution rates in a budget bill).

HB 2350/SB 6563 proposes to merge the LEOFF Plan I and II funds. The bill also subjects the merged fund to the management of what was formerly the LEOFF Plan II Board created by RCW 41.26.700 et. seq. (§ 4). The new merged board would set contribution rates for both LEOFF Plan I and II members and employers (§§ 3, 16). The bill, however, does not specify whether the new combined board would have any responsibility in connection with supervision of the local disability boards' decisionmaking generally, or with respect to medical benefits under RCW 41.26.150 specifically (§ 5). The Board's membership, now consisting of a majority of LEOFF Plan II members and retirees, is unaltered, except that the retiree member could be LEOFF Plan I or II (§ 7). The bill retains the existing provisions of RCW 41.26.715 which provided for 3 firefighters and 3 police officers. *Id.* But in actual practice, with the diminishing number of LEOFF Plan I actives, members are likely to be Plan II. Finally, the bill provides that the new board is authorized to pay "legal expenses that are primarily incurred for the purpose of protecting the trust fund or incurred in compliance with statutes governing the fund" out of "interest earnings" of LEOFF (§ 20).

(2) Legal Issues

In considering the possible merger of LEOFF Plan I and II, a number of legal issues are present. This memorandum by no means considers all of the potential legal issues. However, four legal issues are readily apparent from any proposed merger, including:

(a) Under the decision of the Washington Supreme Court in *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956), are the independent LEOFF I and II funds a contractual benefit of LEOFF members that may not be disturbed under that decision?

(b) Is the local board process of LEOFF Plan I in which local boards make disability and retirement decision and can authorize added medical benefits under RCW 41.26.150, a contractual right of LEOFF Plan I members that cannot be disturbed under *Bakenhus*?

(c) Where the Legislature is excluded from any role in the setting of contribution rates for Plan I and II members, notwithstanding the provisions of Initiative 790 as set forth in RCW 41.26.700 et. seq., do such contribution rates require legislative approval under Initiative 1053 or Article VII, § 5 of the Washington Constitution?

(d) Does the makeup of a combined LEOFF board with its disproportionate (or even an exclusive) number of LEOFF II members violate the rights of LEOFF I members whose pension rights are decided by such a board?

(e) Is the new board's authority to retain independent legal counsel consistent with the constitutional authority of the Attorney General?

(3) Bakenhus-Related Questions

In order to answer questions (a) and (b) above, it is important to understand the rule articulated in *Bakenhus*. In numerous appellate court decisions and AGOs,[4] our Supreme Court addressed the question of legitimacy of changes to laws governing a pension system both for current members or retirees. In general terms, the right to a public pension commences upon the first day of employee's employment and continues to vest with each day of service thereafter. *Tembruell v. City of Seattle*, 64 Wn.2d 503, 506, 392 P.2d 453 (1964). That employee's pension entitlement, based on contract, is in accord with the statutes as they existed when the employee began his/her service. *Mulholland v. City of Tacoma*, 83 Wn.2d 782, 785-86, 522 P.2d 1157 (1974); *Noah v. State*, 112 Wn.2d 841, 845 n.1, 774 P.2d 516 (1989).

Bakenhus, a retired Seattle police officer, sued Seattle, challenging a policy which set a maximum of $125 per month on police pensions. When he commenced his employment with Seattle in 1925, he was entitled to receive one-half of the salary he had received during the last year before his retirement. Bakenhus obtained a judgment directing that he be paid a pension of one-half of his last month's salary and a judgment for the difference between the pension he had been paid from the date of his retirement and the amount he should have received. Our Supreme Court started from the premise that a pension granted to a public employee is not a gratuity but is deferred compensation for services rendered on a contractual basis. *Id.* at 700. Thus, when an employee accepts a job to which a pension plan is applicable, that employee contracts for the pension and is entitled that pension when he/she has fulfilled all of the conditions associated with it. The Court indicated that pension rights may be modified prior to the employee's retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity. 48 Wn.2d at 701. More specifically, citing California authority, our Supreme Court stated that any such modifications to the pension system "must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." *Id.* at 701-02.[5] The Court sustained Bakenhus' rights under the pension system that applied when he began working for Seattle.

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[4] I have generally chosen not to cite the numerous AGOs on pension issues generally and LEOFF issues specifically unless they bear directly on the legal issue discussed herein.

[5] The Supreme Court in *Dailey v. City of Seattle*, 54 Wn.2d 733, 344 P.2d 718 (1959) summarized its holding in *Bakenhus* as follows: "1. That employees who accept employment

In cases subsequent to *Bakenhus*, our Supreme Court rooted its analysis in Article I, § 23 of the Washington Constitution which precludes legislation impairing the obligations of contract. In a recent case addressing the *Bakenhus* rule, our Supreme Court in *McAllister v. City of Bellevue Firemen's Pension Board*, 166 Wn.2d 623, 628, 210 P.3d 1002 (2009) reaffirmed the *Bakenhus* rule that any changes to a pension system could not result in disadvantage to the employee over the employee's former pension plan.

RCW 41.26.040(2) codifies *Bakenhus*, guaranteeing that a firefighter retiring or police officer under LEOFF must not suffer any diminution in benefits that would have available if LEOFF had not been enacted. *McAllister*, 166 Wn.2d at 629.

Washington courts have broadly construed the scope of these contractual rights; they are not confined to pensions alone. For example, service-connected disability rights of a police officer fall within *Bakenhus*. *State ex rel. Johnson v. Funkhouser*, 52 Wn.2d 370, 325 P.2d 297 (1958). *See also, Eisenbacher v. City of Tacoma*, 53 Wn.2d 280, 333 P.2d 642 (1958) (*Bakenhus* not confined to retirement for service pension rights in case of firefighter where pension system covered service/nonservice disability and retirement). *Bakenhus* principles also apply to pension-related benefits negotiated in a collective bargaining agreement between a private employer and employees, *Dorward v. ILWU-PMA Pension Plan*, 75 Wn.2d 478, 452 P.2d 258 (1969), or a public employer and employees, *Internat'l Ass'n of Firefighters, Local 1789 v. Spokane Airports*, 146 Wn.2d 207, 45 P.3d 186 (2002) (airport fire service employees voluntarily agreed to pay Social Security and Medicare, matched by employer contributions; when union opted out of Social Security/Medicare, employer refused to return the employer match for both systems to the employees; Social Security/Medicare contributions fall within *Bakenhus*).

Washington courts have held that a variety of rights, including rights that indirectly affect a pension, are contractual in nature and are not subject to change by Legislature to the disadvantage of the employee or retiree. *See, e.g.,*

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to which pension plans are applicable contract thereby for a substantial pension, and are entitled to receive the same when they have fulfilled the prescribed conditions. 2. That employees (perspective pensioners) will be presumed to have acquiesced in legislative modifications that do not unreasonably reduce or impair existing pension rights; or, stated positively, if the modifications are reasonable and equitable. 3. That an act of the Legislature, making a change in pension rights, will be weighed against pre-existing rights in each individual case to determine whether it is reasonable and equitable. If the over-all result is reasonable and equitable, the employees (prospective pensioners) will be presumed to have acquiesced in the modification; if the over-all result is not reasonable and equitable, there will be no such presumption." *Id.* at 738-39.

Bakenhus, supra (size of a pension); *Weaver v. Evans,* 80 Wn.2d 461, 495 P.2d 639 (1972) (systemic funding of pension system); *Washington Association of County Officials v. Washington Public Employees Retirement System Board,* 89 Wn.2d 729, 733, 575 P.2d 230 (1978) (right to a practice of including certain lump sum payments in the calculation of retirement benefits); *Eagan v. Spellman,* 90 Wn.2d 248, 258, 581 P.2d 1038 (1978) (right to a statutory retirement age at the time of employment); *Horowitz v. Dep't of Retirement Systems,* 96 Wn.2d 468, 635 P.2d 1078 (1981) (rights to refund of pension contributions); *Washington Federation of State Employees v. State,* 98 Wn.2d 677, 679, 658 P.2d 634 (1983) (the right to add to a pension by using accrued vacation pay).

By contrast, the mortality tables for calculating annuity benefits, *King County Employees' Ass'n v. State Employees Retirement Board,* 54 Wn.2d 1, 336 P.2d 387 (1959), or contribution rates, *Charles, supra* are not contractual benefits.

With respect to the first of the two legal questions above, it appears that an aspect of that question has been answered by decisional law. In *Charles, supra,* the Supreme Court held that the right to the systematic funding of a retirement system to maintain its actuarial soundness is a contractual benefit that may not be altered by legislation. 148 Wn.2d at 625. Thus, LEOFF Plan I members are entitled to an actuarially sound and appropriately funded pension system. That argument might extend to maintenance of a separate LEOFF Plan I fund over which LEOFF Plan I members have authority. But clearly to the extent that merger of Plan I and Plan II funds would undercut the actuarial soundness of LEOFF Plan I or impact the appropriate funding of LEOFF Plan I, a merger would violate the *Bakenhus.*

With respect to the second of the two questions, as to medical benefits, the question of whether medical benefits are a contractual right under LEOFF Plan I has not been specifically tested in court. However, in *Navlet v. Port of Seattle,* 164 Wn.2d 818, 194 P.3d 212 (2008), the Supreme Court held that certain lifetime retirement health care and welfare benefits provided pursuant to a collective bargaining agreement between the port and a union which guaranteed the employees who reached retirement the same level of medical and welfare coverage they had received during active employment constituted a vested right under *Bakenhus* that could not be altered.

In AGLO 1975 No. 2, 1975 WL 165841 (1975), the Attorney General specifically concluded that the provisions of RCW 41.26.150 are contractual rights subject to *Bakenhus.* The Attorney General there rejected the contention that benefits under RCW 41.26.150 were not a contractual right of LEOFF Plan I members, noting that such benefits were plainly a part of LEOFF pension system and they were governed by *Bakenhus.*

Thus, in my opinion, the medical benefits of RCW 41.26.150, including the discretionary ability of local disability boards to authorize additional medical benefits for retirees subject to their jurisdiction, constitute vested contractual rights that may not be altered under *Bakenhus.*[6]

(4) Authority of Merged Board to Set Contribution Rates

While RCW 41.26.705(5) purports to confer exclusive authority upon the Board to set contribution rates for LEOFF Plan II members, and the new board would have been given the authority to set contribution rates for LEOFF Plan I members under HB 2350, that authority is circumscribed by the provisions of RCW 43.135.055.[7]

Over the course of the last decade, super majority requirements for the enactment of fees and taxes have been imposed by initiative. Initiative 1053 was adopted by the voters in November 2010. It establishes a 2/3 super majority requirement for the enactment of taxes in RCW 43.135.034. Moreover, RCW 43.135.055 addresses fees and states:

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6 The board may contend that § 5 of HB 2350 guarantees LEOFF Plan I members their benefits. That section states:

> After the merger of law enforcement officers' and firefighters' retirement system plan 1 into the law enforcement officers' and firefighters' retirement system plan 2, each participant in the law enforcement officers' and firefighters' retirement system plan 1 or the law enforcement officers' and firefighters' retirement system plan 2 is entitled to the same benefits immediately after the merger as immediately prior to the merger including, but not limited to, any benefits provided to active or retired members of the law enforcement officers' and firefighters' retirement system plan 1 by city or county disability boards pursuant to RCW 41.26.150. This protection is in addition to any other protections provided by law.

§ 5 guarantees the benefits that existed pre-merger. It does not specifically address the local disability board process nor does it assure LEOFF Plan I members of the rights they possessed under that process to receive enhanced medical benefits, for example.

7 Article VII, § 5 of the Washington Constitution also provides that taxes may only be imposed "in pursuance of law." Under this constitutional provision, a tax must be expressly imposed by statute or local ordinance. *Okeson v. City of Seattle,* 150 Wn.2d 540, 556, 78 P.3d 1279 (2003). But to the extent that the pension contribution rates do not constitute a tax, but rather are a fee, Article VII, § 5 of the Washington Constitution does not apply. *State v. Sheppard,* 79 Wash. 328, 140 Pac. 332 (1914).

> A fee may only be imposed or increased in any fiscal year if approved with majority legislative approval in both the House of Representatives and the Senate and must be subject to the accountability procedures required by RCW 43.135.031.

RCW 43.135.055(1). RCW 43.135.005, the initiative's intent section, makes clear that there must be legislative approval for any fee increase. Section 9 of Initiative 1053 specifically provides that the initiative is to "be liberally construed to effectuate the intent, policies, and purposes of this act."

No definition is set forth in RCW 43.135 for a "fee."[8] *Merriam-Webster's Collegiate Dictionary* (11th ed.) defines a fee as "a fixed charge" or "a sum paid or charged for a service." In addition to RCW 43.135.055, other statutes narrow the fee-setting authority of the Legislature. For example, RCW 82.02.020 limits the authority of local jurisdictions to land use-related impose fees. That statute offers an analogous definition of a "fee" and our courts have broadly construed a "fee" under that statute. For example, in cases arising under RCW 82.02.020, fees, charges, even indirect assessments fall within the scope of the statutory provision. *Isla Verde International Holdings, Inc. v. City of Camas*, 146 Wn.2d 740, 757-58, 39 P.3d 867 (2002); *Citizens for Rational Shoreline Planning*, 155 Wn. App. 937, 942-43, 230 P.3d 1074, *review granted*, 170 Wn.2d 1001 (2010).

The most often litigated question is whether a particular assessment is a fee or a tax. For example, *Covell v. City of Seattle*, 127 Wn.2d 874, 879, 905 P.2d 324 (1995) distinguishes between a tax and a fee. If an assessment is a tax, it may be subject to constitutional limitations. Beginning in *Covell*, the Supreme Court articulated a three-part test to distinguish a fee from a tax; that test looks (1) to whether the purpose of revenue enhancer is to regulate or raise revenue; (2) whether the funds generated are dedicated to a regulatory purpose; and (3) if there is a direct relationship between the assessment and the service received burden created by the payor. There, the Court held that Seattle's residential street utility charge was a tax not a fee. Our Supreme Court and the Court of Appeals have adhered to the three-part test in many subsequent decisions.

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[8] The legality of a decision by the Legislature to lower the statutorily-set contribution rates for pension systems was tested in *Charles*. There, the Supreme Court determined that pension system members had standing to challenge the rate issue and in so doing determined that a pension system is not a trust. Rather, a pension system is a creature of statute. The Court further concluded that the contribution rates were not a contractual right under *Bakenhus* in the absence of specific proof that the lower contribution rates would prevent the effective operation of the pension system, rendering it actuarially unsound. 148 Wn.2d at 625-28.

In my opinion, under that test, the contribution rates do not constitute taxes, but rather are fees. Assessments for purposes that do not involve public revenue have generally been seen by our courts not to be taxes. *State ex rel. Davis-Smith v. Clausen*, 65 Wash. 156, 203, 117 Pac. 1101 (1911) (worker compensation premiums); *Aetna Life Ins. Co. v. Wash. Life & Disability Ins. Guaranty Ass'n*, 83 Wn.2d 523, 538, 520 P.2d 162 (1974) (insurance guaranty assessments for fund to pay claims for liquidated insurers). Further, given the broad judicial interpretation of fees in statutes like RCW 82.02.020, it is likely a Court would deem LEOFF contribution rates to be fees. As such, they do not fall within the purview of article VII, § 5 of our Constitution.

Finally, if the contributions are fees, can the Board impose them without legislative involvement? I do not believe so. The general principle for interpreting statutes adopted by Washington courts is that the most recent and more specific enactment covering a particular issue governs. *Muije v. Dep't of Social & Health Servs.*, 97 Wn.2d 451, 453, 645 P.2d 1086 (1982) (provisions of a specific statute passed subsequent to a general statute will prevail); *Citizens for Clean Air v. City of Spokane*, 114 Wn.2d 20, 37, 785 P.2d 447 (1990). Here, I-1053 is the more recent and specific statute on the issue of legislative approval of fees. Thus, in my opinion, the authority of a combined LEOFF board to impose contribution rates is subject to RCW 43.135.055. The Legislature, not such a board, must establish the contribution rates for LEOFF retirees insofar as contribution rates constitute a fee.

(5) Due Process Issues Associated with Management of Merged LEOFF Fund

LEOFF Plan I is presently managed by the Department of Retirement Systems. RCW 41.50.055. Contributions to that fund are governed by statute. RCW 41.26.080. The liabilities of the LEOFF Plan I system must be funded in accordance with the provisions of RCW 41.45. By contrast, the Board manages LEOFF Plan II fund, RCW 41.26.720(1), although it must work cooperatively with the State Investment Board in doing so. RCW 41.26.732. The Board is made up of eleven members, six of whom are active or retired LEOFF II members.

Under the provisions of HB 2350/SB 6563, the merged board would still very likely have a majority of LEOFF Plan II members, with little representation for LEOFF Plan I members, even though that board would set LEOFF Plan I contribution rates, if such authority is upheld (*see supra*), and it would manage the retirement funds of the LEOFF Plan I members.[9] If, as was contemplated in HB 2097, any LEOFF Plan I "surplus" is designated as a funding source to diminish LEOFF Plan II members' contributions, the new board will have very limited incentives to increase existing LEOFF Plan I member benefits and thereby restricting the funding source for lower Plan II members' contributions. The new board will be inherently conflicted, to the detriment of the former Plan I members.

Washington courts have historically expressed the view that "taxation without representation" violates fundamental constitutional principles relating to voting or due process. Here, of course, no "taxation" is at issue, but the setting of contribution rates and management of the LEOFF Plan I funds substantially impact LEOFF Plan I members, entitling them to fair representation on the unelected board making such decisions, particularly were a court to disagree with my opinion that the contribution rates must be set by the Legislature under RCW 43.135.055.

In *Malim v. Bethiem,* 114 Wash. 533, 196 Pac. 7 (1921), our Supreme Court held that a statute purporting to allow a diking district to assess lands outside the district's boundaries where those landowners had no right to vote in district elections was unconstitutional as it deprived the landowners of the right to free and fair elections under article I, § 19 of the Washington Constitution. *See also, Foster v. Sunnyside Valley Irr. Distr.*, 102 Wn.2d 395, 687 P.2d 841 (1984) (invalidating irrigation district voting statute limiting vote to agricultural land owners).[10] Similarly, in *State ex rel. Tax Commission v. Redd*, 166 Wash. 132, 6 P.2d 619 (1932), the Court overturned an effort by the State Tax Commission to reassess certain property in Franklin County for local tax purposes. The Court held that the Legislature could not take from the people of that county the right to locally assess their property, an action the Court deemed central to their "right of local-self-government secured to them by our Constitution." *Id.* at 139.

In recent cases, however, our Supreme Court has indicated that there is no need for direct representation for affected constituencies on a governmental board if the board is made up of elected officials. In *Granite Falls Library Capital*

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[9] The merged board members are recommended to the Governor by the Washington State Council of Firefighters and WACOPS, organizations whose focus is on their LEOFF Plan II members.

[10] Where the governmental body has general governmental powers, equal protection principles dictate that "one-person, one-vote" must govern. *Cunningham v. Municipality of Metro. Seattle*, 751 F. Supp. 885 (W. D. Wash. 1990) (invalidating make-up of Metro Council made up of mixture of elected and appointed officials on one-person, one-vote grounds). The LEOFF's Board's authority is arguably more narrow than "general government" purposes.

Facilities Area v. Taxpayers of Granite Falls Library Capital Facilities Area, 134 Wn.2d 825, 953 P.2d 1150 (1998), the library capital facilities area was a distinct quasi-municipal corporation that could levy taxes; its governing body was made up solely of three elected county council members. The Court rejected a challenge to the board's makeup on article I, § 19, due process, and equal protection grounds where the voters of the facilities area expressly approved the sale of bonds by the area and the power of the board to levy taxes to pay for the bonds. The Court did not offer a detailed analysis for its conclusion, but it appears that the delegation of taxing power to this board was proper so long as procedural safeguards like the right to vote on the taxing authority constrained the board's actions. *Id.* at 842, 844. *See also, Municipality of Metro Seattle v. City of Seattle,* 57 Wn.2d 446, 454, 357 P.2d 863 (1960) (Metro Council could levy taxes because the Council, though appointed, consisted of elected officials in the region); *Larson v. Seattle Popular Monorail Authority*, 156 Wn.2d 752, 131 P.3d 892 (2006) (Court upholds authority of Monorail board to levy taxes where board was created by voters and consisted of both elected and appointed members); Mathew Senechal, *Revisiting Granite Falls: Why the Seattle Monorail Project Requires Re-Examination of Washington Prohibition on Taxation Without Representation*, 29 Seattle U. L. Rev. 63 (2005).

In sum, in my opinion, no Washington case has authorized the delegation of a significant fiscal power such as the power to tax or impose fees, or to manage hundreds of millions of dollars in pension funds to an unelected board whose make-up is largely devoid of persons selected by, or representative of, the persons affected by the board's decision. A board that has power over vital financial interests of LEOFF Plan I members, that entirely, or even largely, consists of LEOFF Plan II members, whose interests may diverge from those of the LEOFF Plan I members, violates constitutional principles.

(6) The New Board's Authority to Reimburse Legal Expenses

§ 20 of HB 2350/SB 6563 authorizes the board to use the merged LEOFF fund interest earnings to pay legal counsel. Insofar as LEOFF is no longer a trust after *Charles*, but a creature of statute, it is likely this is within the power of the Legislature to do unless it infringes on the authority of the Attorney General. That authority was recently examined by our Supreme Court in *City of Seattle v. McKenna*, 172 Wn.2d 551, 259 P.3d 1087 (2011) and *Goldmark v. McKenna*, 172 Wn.2d 568, 259 P.3d 1095 (2011).

From those decisions, it is clear that the Attorney General will be legal counsel to the new board, RCW 43.10.040, and the board had no authority to employ counsel "to act as attorney in any legal or quasi legal capacity in the exercise of any of the powers or performances of any of the duties specified by law to be performed by the attorney general . . ." RCW 43.10.067. Because the Attorney General not only will represent the board in court, but advises it under RCW 43.10.040, "in all matters involving legal or quasi legal questions . . .", I do not believe § 20 can be read to authorize the board to retain outside counsel, except insofar as the Attorney General determines that the assistance of special assistant attorney general is required. This section cannot be construed to limit or circumvent the normal payment for legal services to the Attorney General pursuant to the legal services revolving fund process or legal expenses beyond those that are reasonable. RPC 1.5(a).

(7) Conclusion

To summarize,

- The LEOFF Plan I and II merger contemplated by HB 2350/SB 6563 violates the constitutional prohibition on impairment of contract as discussed in *Bakenhus* and its progeny if the fund merger undercuts the actuarial soundness of LEOFF Plan I. It may be unconstitutional per se in the elimination of a separate LEOFF Plan I fund. It is unconstitutional as to the possible elimination of local disability boards.

- Under RCW 43.135.055, only the Legislature may set contribution rates as they are fees.

- The management of merged funds by a new board created by HB 2350/SB 6563 with limited LEOFF Plan I member representation violates the due process rights of LEOFF Plan I members.

- The proposed reimbursement of legal expenses in HB 2350/SB 6563 from fund interest earnings is constrained by the constitutional and statutory authority of the Attorney General.

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January 12, 2012

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**VIA EMAIL AND
FIRST CLASS MAIL**

RE: Analysis of House Bill 2350

Dear LEOFF I Coalition Chair and Board Members:

By email of January 10, 2012, you have asked that I analyze what has become HB 2350, the latest attempt to merge Plan 1 and Plan 2 of the Washington Law Enforcement Officers and Fire Fighters Retirement System. I have reviewed the Bill in considerable detail and will present my views in the paragraphs that follow.

OVERVIEW

By way of an overview, let me say that this Bill is no less insidious and harmful to LEOFF I members than was HB 2097. Although it is, in many respects, quite similar to HB 2097, there are a few significant differences. The present Bill, HB 2350, is likely to appear to the casual reader as quite a bit better than HB 2097; however, in reality, it is not. I can find nothing to recommend it to LEOFF I members. In the next few paragraphs I will discuss a few of my concerns and call to your attention some of the sections which you may wish to consider carefully.

SECTION 1

Subsection (1) of Section 1 merely sets the contribution rates retroactively for the biennium, from July 1, 2011 through June 30, 2013. The second paragraph, however, Subsection (2) of Section 1 contains language that suggests that the contribution rates can be raised to reflect the cost of "additional benefits." More about this in later paragraphs.

SECTION 3

Very little needs to be said about Section 3 of the Bill. A point of clarification should be mentioned, however. In Subsection (1)(a) of Section 3 the term "member" should be changed to read either "active member" or "employee" to avoid any confusion. Pensions received by LEOFF I members have been held by our courts to constitute "deferred compensation." The change that I have suggested would make it clear that no money is to be withheld from the pensions of retired members, and that contributions are to be deducted only from the compensation of *active* members.

SECTION 5

As you know, LEOFF I members receive medical benefits from two sources under the Act. The first is RCW 41.26.030(19) which enumerates a laundry list of healthcare services which are mandatory in nature, and are clearly contractual, and therefore, come under the protection of *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (Wash. 1956). The second source of healthcare benefits enjoyed by LEOFF I members is the designation of additional medical services by local Disability Boards. These additional medical services may be regulated and controlled by the Disability Board having jurisdiction over the member. One responsibility of each Disability Board is to oversee the provision of all healthcare services received by LEOFF I members, whether received under RCW 41.26.030(19) or under RCW 41.26.150(1)(b), and to approve the payment for such healthcare services.

At first glance, this new section would appear to preserve the present system of providing healthcare benefits to LEOFF I members, but on a closer reading, one realizes that there is no provision in this section, or in any other section of the Bill for that matter, which would preserve local Disability Boards to administer these healthcare benefits. Since the first sentence of this section makes it clear that Plan 1 is being merged ***into*** Plan 2, and because of other language in the Bill, it would appear that the administration of all benefits, including the healthcare benefits for LEOFF I members are to be handled by the LEOFF II Board. In the event that this Bill goes much further toward becoming a law, you should have me research the constitutional aspects of the Bill, and whether this provision would violate *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (Wash. 1956).

Local Disability Boards would appear to have no further purpose under this Bill. Certainly there would be no way for a Disability Board to designate additional healthcare benefits for LEOFF I members. Judging from the composition of the Board of Trustees as set forth in Section 7 of the Bill, I think that the likelihood of a subsequent grant of additional healthcare benefits is highly unlikely. The other question is exactly how the Board of trustees is expected to manage the administration of healthcare benefits for LEOFF I members that are presently administered by scores of local Disability Boards, especially when the additional medical services these Boards grant the members under their jurisdiction are so very different for each Board and group of members. This provision has the makings of a complete disaster.

SECTION 6

Section 6 is a definitional section. Definitions contained in a Bill or a Statute are extremely important, and must be read very carefully. You will note that, while the previous section seems to say that LEOFF I members retail all benefits, including healthcare benefits, that they enjoyed before the merger, the present section contradicts that notion and confuses the issue.

Subsection (8) of Section 6 creates a category of benefits called "minimum benefits" which it defines as "those benefits provided for in chapter 41.26 RCW as of July 1, 2003." Subsection (11) of Section 6 creates a second category of benefits which it calls "increased benefits" which the section defines as "a benefit in addition to the minimum benefits." From these two subsections it would appear, with regard to healthcare benefits, that a distinction must be drawn between those medical benefits granted by a particular Disability Board on of before July 1, 2003 and those granted by each Disability Board subsequent to that date. The former will be "minimum benefits," while the latter will constitute "increased benefits." This is an important distinction as we will see as we read further into this Bill.

Before leaving Section 6, we should also look at Subsection 13 of Section 6 which is more than just a little confusing. That subsection reads, in part, as follows:

> (13) "Benefits" means the age or service or combination thereof required for retirement, the level of service and disability retirement benefits, survivorship benefits, payment options including a deferred retirement option plan, average final compensation, *postretirement cost-of-living adjustments, **including** health care and the elements of compensation.* (Emphasis provided)

I have no idea what the word "including" means in this context. It appears to be trying to include healthcare benefits and "elements of compensation" as a part of cost of living adjustments. If the word "including" were struck fron the section it would work better.

<u>SECTION 7</u>

The interesting thing about Section 7 is that the police and fire fighter members of the Board of Trustees can all be Plan 2 members. Certainly the Bill would allow the appointment of one or more Plan 1 members to the Board of Trustees, but there is no requirement that even a single Plan 1 member be on the Board of Trustees. Given the vast differences between Plan 1 and Plan 2 members with regard to the nature and level of benefits enjoyed by each group; and given the increased level of disharmony that exists between them, especially after last years introduction of HB 2097; it seems unlikely that LEOFF I members will get a fair shake from the Board of Trustees. Even if the Board of Trustees does its best to treat active and retired Plan 1 members fairly, the confusion and problems discussed in the preceding section of this letter will make it all bet impossible. Local Disability Boards MUST be kept in place to administer the benefits that they presently administer for LEOFF I members.

To the extent that local Disability Boards are being eliminated by this Bill, and in the event that this Bill goes much further toward becoming a law, you should have me research the constitutional aspects of the Bill, and whether or not this elimination of Disability Boards violates the rule of *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (Wash. 1956).

<u>SECTION 9</u>

This section sets out a number of powers and duties of the Board of Trustees. Subsection (1)(b)(i) provides a very complex way in which the

Board of Trustees may, should it choose to, provide increased benefits. It specifically provides as follows:

> (b)(i) Provide for the design and implementation of increased benefits for members and beneficiaries of the plan, *subject to the contribution limitations under RCW 41.26.725.* <u>An increased benefit may not be approved by the board until an actuarial cost of the benefit has been determined by the actuary and contribution rates adjusted as may be required to maintain the plan on a sound actuarial basis.</u> *Increased benefits as approved by the board shall be presented to the legislature* on January 1st of each year. <u>The increased benefits as approved by the board shall become effective within ninety days unless a bill is enacted in the next ensuing session of the legislature, by majority vote of each house of the legislature, repealing the action of the board;</u>

Given the complexity of this, I wonder if any "increased benefits" will ever make it to the members who need them. At present, as you know the matter of increasing provided healthcare services for members is within the discretion of the various local Disability Boards, and is accomplished quite simply by a vote of the Board. I would be very surprised to ever see any increase in discretionary healthcare benefits for those who are presently Plan 1 members, especially since the merging of the two plans would, for all practical purposes, require any such increased benefits to apply not only to the relatively few remaining Plan 1 members, but to all LEOFF members, Plan 1 and Plan 2, alike.

Subsection (b)(ii) of Section 9 is poorly written and too confusing to understand just what it is trying to accomplish, or to predict just what problems it will cause or solve.

Subsection (d) of Section 9 empowers the Board of Trustees to "consult with the department for the purposes of improving benefit administration and member services. It would seem that local Disability Boards are out of the picture, as they seem to have no more responsibility under this Bill. Once again, this is an area which will require some additional research if it appears that this Bill is moving ahead with any momentum.

<u>SECTION 10</u>

Section 10 of the Bill deserves some careful scrutiny. It is fraught with potential problems. Subsection (1) of Section 10 reads as follows:

> (1) The board of trustees shall establish contributions as set forth in this section. The cost of the ((~~minimum benefits as defined in this plan~~)) <u>combined plan 1 and plan 2 benefits</u> shall be funded on the following ratio:
>
> Employee contributions 50%
> Employer contributions 30%
> State contributions 20%

My question with regard to this subsection is be whether its intent is to require LEOFF I members to pay 50% of the cost of their healthcare benefits. I doubt that this is the intent, but the Subsection is certainly not clear at all. It should be clarified with specific language so as to avoid any question in this regard.

Subsection (2) of Section 10 of the Bill reads, in part, as follows:

> (2) <u>The minimum benefits shall constitute a contractual obligatio</u>n of the state and the contributing employers <u>and may not be reduced below the levels in effect on July 1, 2003.</u> (Emphasis added).

While safeguarding the contractual nature of the "minimum benefits (those in effect on or before July 1, 2003) the subsection would seem to be suggesting that the additional benefits acquired after that date are not contractual in nature and may be reduced or eliminated all together. The question, of course, is what does this mean for those additional medical and healthcare services designated by our local Disability Boards as available to LEOFF I members after July 1, 2003. In most cases, this will include dental benefits and other healthcare procedures not approved by Disability Boards as of July 1, 2003.

Subsection (3) of Section 10 of the Bill is also somewhat unclear, and appears to present some problems. It reads, in part, as follows:

> (3) Increased benefits created as provided for in RCW 41.26.720 are granted on a basis not to exceed the contributions provided for in this section. **In addition to** the contributions necessary to maintain the minimum benefits, for any increased benefits provided for by the board, the employee contribution shall not exceed fifty percent of the actuarial cost of the benefit. In no instance shall the employee cost exceed ten percent of covered payroll without the consent of a majority of the affected employees. Employer contributions shall not exceed thirty percent of the cost, but in no instance shall the employer contribution exceed six percent of covered payroll. State contributions shall not exceed twenty percent of the cost, but in no instance shall the state contribution exceed four percent of covered payroll. Employer contributions may not be increased above the maximum under this section without the consent of the governing body of the employer. State contributions may not be increased above the maximum provided for in this section without the consent of the legislature. In the event that the cost of maintaining the increased benefits on a sound actuarial basis exceeds the aggregate contributions provided for in this section, the board shall submit to the affected members of the plan the option of paying the increased costs or of having the increased benefits reduced to a level sufficient to be maintained by the aggregate contributions. The reduction of benefits in accordance with this section shall not be deemed a violation of the contractual rights of the members, provided that no reduction may result in benefits being lower than the level of the minimum benefits.

This subsection may be read as requiring members to pay 50% of the cost of any "increased benefits." Given the fact that an "increased benefit" is defined as "a benefit in addition to the minimum benefits," and the term "minimum benefits" is defined as "those benefits provided for in chapter 41.26 RCW as of July 1, 2003;" LEOFF I members could be required to pay 50% of the cost of all healthcare benefits granted them by their local Disability Board after July 1, 2003. I do not believe that such is the intention of this section of the Bill; however, it is a possible, and even likely reading of this section of the bill.

Also of note is the provision in this subsection that provides that anytime that the cost of maintaining increased benefits exceeds the existing contribution levels, the Board of Trustees must submit to the members the option of paying for the benefits or having them reduced. The subsection also specifically provides that any such reduction in benefits is not to be construed as a violation of the contractual rights of members.

SECTION 18

subsection (2) of Section 18 of the bill requires the Department of Retirement Systems to: "establish supplemental rates to pay for the cost of additional benefits, if any, granted to members of the law enforcement officers' and firefighters' retirement system." While the Department has that mandate now as to Plan 2 members, this section extends that requirement to include Plan 1 members. It should be noted that the term used in this section is "additional benefits," a term not previously defined. I suspect that it is an oversight, and that "increased benefits" is the intended term.

SECTION 19

Subsections (1) and (2) of Section 19 would seem to divest the Public Safety Subcommittee and the Select Committee on Pension Policy of their oversight of the Law Enforcement Officers and Fire Fighters Retirement System, in favor of to Board of Trustees as constituted by this Bill.

SECTION 20

Although not of overwhelming importance, Subsection (2) of Section 20 provides that all legal expenses and litigation costs incurred primarily in the protection of the fund or incurred in compliance with the statutes governing the fund are to be paid from the interest earnings of the fund – your money.

While I believe that the sections discussed above are the only ones that need to be discussed at this time, I do believe that it will be necessary to watch this Bill carefully for changes and for its progress toward becoming the law of the land.

In the event that this Bill moves along to the point that it is likely to become law, you should again retain me to research the various issues relating to the constitutionality of the various provisions that are problematic for LEOFF I members, so that we can stay ahead of the State on that issue. I do not see any need to spend the time and money for such research at this time, since we do not know how far this Bill will get. I will remain ready to conduct any such legal research and analysis as the LEOFF I Coalition and its Board deems appropriate.

The discussions set forth in this letter should give you a very good idea of what provisions of the Bill are of the most concern, and also give you some talking points for discussions with legislators about the problems with this piece of legislation.

Thank you for allowing me to be of service.

Very truly yours,

J.E. Fischnaller

EXHIBIT D

A. Ice Miller Analysis

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LEGAL COUNSEL

L-2 Board
Select

October 5, 2011

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Re: OSA Study

Dear Dave, Aaron, Lisa and Anne:

This letter and attached materials have been prepared in response to Dave's e-mail of August 7, 2011 and our telephone conversation of August 22, 2011. This also includes additional questions and comments by Aaron dated September 20 and September 29, 2011.

It is our understanding that the Office of the State Actuary ("OSA") has been asked to perform a study of the merger of LEOFF Plan 1 and LEOFF Plan 2. OSA and the Washington Department of Retirement Systems ("DRS") will enter into an interagency agreement to provide resources for the study. OSA will be handling the actuarial analysis of the merger, but also needs to understand if such a merger would be possible from a federal law perspective. DRS has agreed to provide legal support on this issue through their contractual arrangement with Ice Miller LLP. OSA and DRS are also asking the Attorney General's office to provide a state law analysis.

Based upon the information that you have provided to us, we understand that we are to provide you with information from a federal law perspective on the following questions.

1. What are the tax and legal "ground rules" for a plan merger, generally?

    a. If any public pension system wanted to merge plans, what issues should be considered?

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b. Are certain actions prohibited, or potentially problematic?

i. For example, are systems prohibited from merging all assets and liabilities?

2. Is Ice Miller aware of any federal law issues specific to Washington?

a. Are there high-level issues that stand out based on Ice Miller's knowledge of Washington's retirement plans?

b. Does it matter if the LEOFF Plan 1 is merged into LEOFF Plan 2, or vice versa?

TERMINOLOGY

Before responding to your questions, we want to consider the possible meanings of the word "merger." As discussed below, under the Internal Revenue Code ("Code") "merger" has a very distinct meaning – it is the actual merger of assets and liabilities into a single plan, where the assets and the liabilities are "usable" across the plan. However, policy makers may wish to consider other forms of joint administration of the two plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – DRS administers both LEOFF Plan 1 and LEOFF Plan 2 and the Washington State Investment Board handles the investments for both plans. However, there are differences in governance. For example, LEOFF Plan 2 is governed by the LEOFF Plan 2 Board of Trustees; LEOFF Plan 1 retains local disability boards.

OVERVIEW OF FEDERAL LAW - MERGER

In this section of this letter we consider the "ground rules" for a plan merger – the rules that would apply to any merger of assets and liabilities in a governmental plan.

Source of Guidance

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. Governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are subject in many cases to pre-ERISA guidance from the Internal Revenue Service ("IRS"). Governmental plans may also follow ERISA provisions by analogy.

Exclusive Benefit Rule

Code § 401(a) requires that the plan of the employer be "for the exclusive benefit of [the employer's] employees or their beneficiaries . . . ." Therefore, the plan may not benefit a person other than the employees or their beneficiaries. Accordingly, the IRS has held that "funds

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accumulated under a qualified plan in trust are intended primarily for distribution to employee participants." Rev. Rul. 72-240, 1972-1 C.B. 108. This exclusive benefit requirement applies to all qualified pension plans, including governmental plans, and, therefore, must be considered in any plan merger.

Qualified Plan Status

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. Therefore, in a merger of governmental plans, it is important to ascertain or confirm the qualified status of each plan prior to the merger, as well as the qualified status of the "surviving" plan.

Consideration of Termination Issues

Pre-ERISA guidance also provides that, if the merger results in the termination of one plan, then all accrued benefits under the terminating plan must be 100% vested to the extent that benefits are funded. Code § 401(a)(7)(1974). Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. A plan is not considered to be terminated merely because an employer consolidates or replaces that plan with a comparable plan. Treas. Reg. § 1.401-6(b)(1); Rev. Rul. 67-213, 1967-2 C.B. 149. A comparable plan is not necessarily one of the same type, but it is one of the same category (e.g., defined benefit vs. profit-sharing). Rev. Rul. 67-213 (citing Treas. Reg. § 1.381(c)(11)-1(d)(4)). Therefore, in a merger of qualified defined benefit plans, the IRS could find that the merged plans had not terminated, but that determination is based on all the facts and circumstances.

Participant Elections

In some cases, policy makers wish to give plan participants the option of whether or not to be part of a merger. It is permissible to give participants the option of moving from one plan to another so long as there is no option to receive a distribution. Rev. Rul. 67-213. However, in a governmental plan, giving existing employees a choice among plans will currently not be approved by the IRS if the choice impacts the employees' pre-tax contributions. Revenue Ruling 2006-43, 2006-35 I.R.B. 329.

Assets/Liabilities

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of assets and liabilities/benefits. Code Sections 401(a)(12) and 414(*l*) establish merger requirements for private sector plans, which requirements are intended to demonstrate compliance with the exclusive benefit rule. Government plans, such as LEOFF Plan 1 and LEOFF Plan 2, are not required to follow these merger rules. Treas. Reg. § 1.414(*l*)-1(a)(1). However, we believe that certain essential elements of these federal laws provide a good road map for a merger of plans and would demonstrate to the IRS the intent of

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the legislature to comply with the exclusive benefit rule. Code § 401(a)(12) provides that, in the case of a merger, consolidation or a transfer of assets or liabilities, each participant must receive benefits on a termination basis from the plan immediately after the merger or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation or transfer. See also Treas. Reg. § 1.414(*l*)-1(a)(2). A "merger" or "consolidation" means the combining of two or more plans into a single plan.... [A] merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan." Treas. Reg. § 1.414(*l*)-1(b)(2).

> A 'transfer of assets or liabilities' occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding media used for a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities.

Treas. Reg. § 1.414(*l*)-1(b)(3). The term "benefits on a termination basis" means the benefits that would be provided exclusively by the plan assets pursuant to ERISA § 4044 and the regulations thereunder if the plan terminated. Treas. Reg. § 1.414(*l*)-1(b)(5). As noted above, for governmental plans, the pre-ERISA minimum vesting standards require 100% vesting of benefits accrued to the date of termination upon normal retirement and upon plan termination or discontinuance of employer contributions.

Benefit Changes

To the extent that a merger results in there being benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law. However, from a federal law perspective, the accrued benefit of a plan member who has reached normal retirement age under the plan must be protected.

Plan Terms

Any qualified plan must follow its written terms and conditions. Thus, any transaction, such as a merger, must be reflected in each involved plan's terms via an amendment. This must be done before the merger occurs. The terms of the merger could be that one plan merges into the other. Alternatively, the terms could be that a new plan is created and both existing plans would merge into the new plan.

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Taxation

To confirm that the merger of one plan into another does not have a taxation impact on the members, our clients have typically sought a private letter ruling ("PLR") from the IRS.

On-going Compliance Post Merger

After the merger, the merged plans must be maintained in compliance with Code Section 401(a).

OVERVIEW OF FEDERAL LAW – CONSOLIDATION

In the case of consolidation, the exclusive benefit rule must be applied – in that the plan assets of one plan could only be used for the benefit and expenses attributable to that plan.

In a consolidation, the above described issues of maintenance of qualified status, participant elections, and plan terms would still need to be considered. However, consolidation does not raise issues with regard to vesting and valuation of benefits on a termination basis.

CONSIDERATION OF SPECIFIC ISSUES

Based upon our discussions with you, we understand that the proposed transaction could be any of the following (we have shown what we assume are the most likely scenarios). The attached chart addresses how these scenarios should be considered.

Merger of LEOFF 1 and LEOFF 2:

LEOFF 1 → LEOFF 2 (merger of assets and liabilities; no change in benefits)

LEOFF 2 → LEOFF 1 (merger of assets and liabilities; no change in benefits)

LEOFF 1 → LEOFF 2 (new tier with new benefits formula and/or benefit provisions and all assets and liabilities merged)

Under the Pre-ERISA rules, the merger of one plan into another plans would not be considered a termination if a qualified plan is replaced by a comparable plan (a plan of the same type) and so long as the plan assets are not distributed to the members. Therefore, from a termination perspective, it will not matter if LEOFF Plan 1 is merged into Plan 2 (or vice versa), because two conditions are met:

1. Both LEOFF Plan 1 and LEOFF Plan 2 are the same type of plan – qualified defined benefit plans under IRC Section 401(a); and

2. No distribution will be made of plan assets to active participants.

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Using Code § 414(*l*) as a guide, participants must be entitled to receive the same benefit after a merger or transfer of assets as they would have received before the merger. The calculation of those benefits is done on a termination basis. So, under the 414(*l*) model, the benefits have to be tested as though there had been a termination, even though there is not a termination. This testing of benefits would apply if LEOFF Plan 1 is merged into LEOFF Plan 2 (or vice versa).

If the merger of the two plans results in a lower cost and thus a lower required contribution rate, federal law would not dictate whether the employers' or the employees' contributions were adjusted. That would be a matter of state law and plan design.

Merger of LEOFF 1 and LEOFF 2 into a New LEOFF:

LEOFF 1 and LEOFF 2 → New LEOFF (new tier(s) with new benefits formula and/or provisions; assets and liabilities merged)

If the two plans were to merge into a single new LEOFF Plan 3, policy makers could choose that the benefits could stay exactly the same (two tiers incorporating current provisions), or there could be a new structure with new benefits (for example, all LEOFF Plan 3 members have the same retirement eligibility, *etc.*)

We understand the Washington AG's office is going to be advising with respect to whether benefits can be changed as part of the merger from a state law perspective.

From a federal tax law perspective, a plan participant who has reached normal retirement age or reached other vested status under the plan must be vested in his accrued benefit as of that date. It is our understanding that every participant in LEOFF Plan 1 has reached normal retirement age under the terms of the plan and has met all requirements for vesting. If our understanding is correct, then benefits accrued to date for participants in LEOFF Plan 1 cannot be changed in any merger. To the extent that participants in LEOFF Plan 2 have reached normal retirement age and met requirements for vesting, those benefits accrued to date also cannot be changed. Therefore, any benefit change that is adopted as part of a merger could only affect new members, non-vested members, and vested members prospectively.

Consolidation:

LEOFF 1 and LEOFF 2 → New LEOFF consolidation of administration of benefit plans; no change in benefits; with on-going segregation of assets and liabilities.

From a federal tax law perspective, there would be fewer issues to address – primarily the exclusive benefit rule.

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IRS APPROVAL

If some type of merged or consolidated plan is passed by the legislature, then we recommend that DRS and/or the LEOFF Plan 2 Board seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. This would be done in the next Cycle C, which opens February 1, 2013 and closes January 31, 2014. That would likely result in a 2015-2016 determination letter issuance.

If some type of transfer is passed by the legislature, then we also recommend that DRS and/or the LEOFF Plan 2 Board seek a PLR to confirm that the transfer does not result in any tax consequences to any affected members.

Very truly yours,

ICE MILLER LLP

Mary Beth Braitman

Mary Beth Braitman

Terry A M Mumford

Terry A.M. Mumford

/jls
Attachment

CIRCULAR 230 DISCLOSURE

Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

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