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Attorneys for California Public Employees' Retirement System

**UNITED STATES BANKRUPTCY COURT**

**EASTERN DISTRICT OF CALIFORNIA**

**SACRAMENTO DIVISION**

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| In re:<br>CITY OF STOCKTON, CALIFORNIA,<br>Debtor. | Case No. 12-32118 (CMK)<br>D.C. No. OHS-15<br>Chapter 9<br>Adv. Proceeding No. 13-02315-C |
| WELLS FARGO BANK, NATIONAL ASSOCIATION, FRANKLIN HIGH YIELD TAX-FREE INCOME FUND, AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND,<br>Plaintiffs.<br>v.<br>CITY OF STOCKTON, CALIFORNIA,<br>Defendant. | **CALPERS' RESPONSE TO FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND'S EVIDENTIARY OBJECTIONS TO DIRECT TESTIMONY DECLARATION OF DAVID LAMOUREUX IN SUPPORT OF CALPERS' RESPONSE TO FRANKLIN'S OBJECTION TO CONFIRMATION OF THE CITY OF STOCKTON'S FIRST AMENDED PLAN OF ADJUSTMENT**<br>Date: May 12, 2014<br>Time: 9:30 a.m.<br>Dept: C, Courtroom 35<br>Judge: Hon. Christopher M. Klein |

The California Public Employees' Retirement System ("CalPERS") respectfully submits the following responses to the objections of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund (collectively, "Franklin") to the *Direct Testimony Declaration Of David Lamoureux In Support Of CalPERS' Response To Franklin's Objection To Confirmation Of The City Of Stockton's First Amended Plan Of Adjustment* (the "Lamoureux Decl.") [Dkt. Nos. 1439-1444].

CalPERS submits that all of Franklin's objections to the Lamoureux Decl. are without merit. Furthermore, CalPERS submits that Franklin will have the opportunity to cross-examine Mr. Lamoureux at trial in order to raise any alleged deficiencies in his declaration. To the extent the Court determines that any statements contained in Mr. Lamoureux's declaration require additional clarification or additional foundational support, CalPERS is prepared to present live testimony from Mr. Lamoureux at trial in order to lay the necessary foundation or provide clarification.

CalPERS provides the following specific responses to Franklin's objections to the Lamoureux Decl.:

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| 6. The role of a pension actuary is to determine how much money must be contributed to a pension plan each year in order to properly fund the benefits promised to employees that will become due in the future. This is done through analysis of the financial consequence of risk. Actuaries use mathematics, statistics, and financial theory to study uncertain future events, particularly those of concern to insurance and pension programs. For example, pension actuaries analyze probabilities related to the demographics of pension plan members (*e.g.*, the likelihood of retirement, disability and death) and economic factors that may affect the value of benefits or the value of assets held in a pension plan's trust (*e.g.*, investment return rate, inflation rate and rate of salary increases). Pension actuaries | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. This paragraph provides a basic overview of actuarial science, which is relevant to the City's relationship with CalPERS because it goes directly to how certain rates the City pays to CalPERS are calculated. |

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| determine the value of pension benefits and devise strategies for funding the cost of the benefits that ensure benefits are properly funded and maintain inter-generational equity (*i.e.*, achieve equity across generations of taxpayers, by funding the employees' benefits while they are rendering service, so that the cost of the benefits is incurred by the taxpayers receiving services from those employees). | | |
| 7. <u>CalPERS is a statutorily created arm of the state of California</u> that functions as a third party administrator for the pension system for California public employees, which includes approximately 2,600 separate plans. The California Legislature established CalPERS in 1932, in the midst of the Great Depression, to provide retirement benefits to California State employees. Beginning in 1939, public "agencies" (including municipalities like Stockton) were allowed to elect to participate in CalPERS. Ex. 1, Vested Rights of CalPERS Members (July 2011) at 2 ("CalPERS Profile"). CalPERS administers the State's pension plan and healthcare services for almost 1.7 million California public employees, retirees, and their families. Ex. 2, CalPERS Office of Public Affairs, *Facts at a Glance* (April 2014). | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. With respect to the second objection, that is what California law says. Numerous federal courts have determined that CalPERS is an "arm of the State of California" for purposes of Eleventh Amendment immunity and jurisdictional purposes. The Court can take judicial notice of those cases and the relevant California law. |
| 8. The CalPERS Board is governed by the California Constitution and statutes, such as Cal. Const., art. XVI, § 17 subdiv. (b), <u>which mandates that the CalPERS Board ensure the rights of CalPERS members and retirees to their full earned benefits</u>. In 1992, California voters approved Proposition 162, which gave the CalPERS Board exclusive authority over the administration and investment of pension funds. <u>In enacting Proposition 162, the electorate amended article XVI, section 17 of the</u> | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they are either (a) are improper legal conclusions (FED. R. EVID. 701); and/or (b) Mr. Lamoureux's description of the California Constitution is not the best evidence of that document (FED. E. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. With respect to the second objection, again, the California Constitution, and the cases interpreting it, says what it says and this |

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| California Constitution, to read in part as follows:<br><br>Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to . . . the following: [¶] . . . The retirement board shall . . . have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries.<br><br>Ex. 3, (relevant portions of official ballot pamphlet (Nov. 3, 1992)). Proposition 162 amended the California Constitution to provide that the CalPERS Board has "the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets" of the system. Cal. Const., art. XVI, § 17, subdiv. (e). The intent behind the measure was to protect public pension funds 4 by vesting the authority to direct actuarial determinations solely with the CalPERS Board. Ex. 3 at 36 (relevant portions of official ballot pamphlet (Nov. 3, 1992)). By granting the CalPERS Board sole authority to administer the system, Proposition 162 prevented the legislative and executive branches from "raiding" pension funds to balance the State budget. *Id*. at 38. | EVID. 1002). | testimony is not a legal conclusion because it explains CalPERS' understanding of these provisions. As for the third objection, again, the law and legislative history, which is attached as an exhibit, says what it says and the Court can take judicial notice of what it says. |

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| 9. The CalPERS Board is governed by the California Public Employees Retirement Law (the "PERL"), which imposes statutory obligations on the Board and employers such as the City of Stockton. Under the PERL, Stockton has certain obligations to CalPERS, and CalPERS in turn has obligations to the City of Stockton's current and former employees to provide retirement benefits in accordance with the provisions of PERL. These statutory obligations are not directly affected by the acceptance, rejection or modifications of the City's collective bargaining agreements. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. As for the second objection, again, the law says what it says and the Court can take judicial notice of it. |
| 10. For public employees serving municipalities in California, the legislature created a three-party structure under which CalPERS provides retirement benefits. First, each municipality elects a "contract" with CalPERS that triggers the applicability of statutes including the PERL and other laws, regulations and policies governing the provision of pension benefits through CalPERS. Second, each public servant has an employment contract with the municipality that includes pension benefits. Finally, CalPERS has a constitutionally defined responsibility to provide pension benefits to its members and retirees and to protect these benefits. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | See Response to ¶ 9. |
| 11. Less than one hundred agencies have terminated their relationship with CalPERS in the more than eighty years of the existence of the system. <u>Virtually all of these terminating agencies are very small local districts or agencies and most employers have terminated because they are winding up their operations and ceasing business. No employer the size of the City of Stockton has ever terminated its relationship with CalPERS.</u> CalPERS administers a terminated agency pool for agencies that terminate their relationship with CalPERS. As of June | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they are vague, speculative, and lack foundation. FED. R. EVID. 602. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. As CalPERS' Deputy Chief Actuary, the witness has direct knowledge of these facts based upon his personal review of CalPERS' |

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| 30, 2012, there were 90 agencies that had terminated their contract with CalPERS for which CalPERS continues to administer benefits through the terminated agency pool. As of June 30, 2012, the terminated agency pool held about $178 million in assets and $89 million in pension obligations. These pension obligations covered 740 members and/or beneficiaries currently receiving a benefit and 349 members that have not yet retired 5 but are entitled to a deferred retirement benefit. By comparison, the termination liability for the Stockton plans alone would affect approximately 2,518 members that have not yet retired but are entitled to a deferred retirement benefit and 2,075 members and/or beneficiaries currently receiving a benefit, and would result in termination obligations exceeding $2.6 billion for both plans while the assets as of June 30, 2012 totaled about $1 billion. | | business records. |
| 12. Of the more than 1500 public agencies that contract for pension services with CalPERS, none of them (other than the bankrupt City of San Bernardino) were delinquent by an amount in excess of $150,000 as of March 31, 2013. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony is relevant because it undercuts Franklin's theory of the case--that pensions administered by CalPERS are financially problematic for municipalities in California. |
| 13. The basic premise of a defined benefit pension plan is to defer compensation received during employees' peak earning years to their lowest earning years. The amounts of such deferred payments are determined based on actuarial assumptions and calculations, and the risk is pooled among the participants in the plan. <u>For a homogeneous population, predictions</u> | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they contain improper opinion testimony that is not rationally based | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. Again, given the |

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| for larger groups are more accurate than for smaller groups. Accordingly, as a pool is made smaller and smaller, the volatility of the cost per member increases because the risk is pooled among a smaller group. | on Mr. Lamoureux's perception and not helpful to clearly understand Mr. Lamoureux's testimony or to determine a fact in issue. FED. R. EVID. 701. | witness is the Deputy Chief Actuary for CalPERS, the witness has personal knowledge of these facts. Moreover, it is not a legal conclusion; rather, it explains the basics of actuarial science, which the witness is more than qualified to testify about. |
| 14. The sources of funds used to provide the pension benefits are employee contributions, employer contributions and investment income. Employee contributions are set by statute and vary by benefit level. Under pension reform enacted by the California legislature in 2011, new employees must pay half of the "Normal Cost," which is the annual cost of service accrual for the upcoming fiscal year for active employees in the absence of any unfunded or overfunded liability to be amortized. Normal Cost is expressed as a percentage of the employer's covered payroll. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. Further, this is not a legal conclusion as it explains CalPERS' understanding of recent reforms and further explains how rates are calculated. |
| 15. A city's contribution obligations to CalPERS are determined on an actuarial basis, taking into account investment returns, mortality rates, projected retirement pattern, projected compensation and other factors. All actuarial calculations are based on a number of assumptions about the future such as demographic assumptions including the percentage of employees that will terminate, die, become disabled and retire each future year and economic assumptions including 6 future salary increases for each active employee and future investment returns. The key role of the actuary is to spread this cost over time in a manageable way. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS and how it functions, and is therefore relevant under Franklin's theory of the case. |

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| 16. Investment income is based on actual performance but must be estimated in order to determine future employer contributions. Investment returns are obviously dependent on global financial circumstances and vary from year to year. The historical average annual return for CalPERS investments over the past 30 years is 9.5%. Ex. 4, (Depicting CalPERS' historical returns from fiscal year 1983-84 to fiscal year 2012-13). Presently CalPERS employs an estimated expected return rate of 7.5% in order to determine contributions, but as can be seen from the historical data, actual returns may vary significantly from that estimate. Assumptions about the investment return/discount rate are not based on investment targets or benchmarks but are instead driven by asset allocations. As asset allocations change, investment return assumptions are revised. The current investment return assumption is 7.5%, which is a combination of 2.75% for inflation and a real rate of return of 4.75% (net of investment and administration expenses). | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. Moreover, it helps explain how CalPERS' rates are determined, which Franklin has put at issue in this case. |
| 17. The benefits under CalPERS are pre-funded. Instead of allocating money at or near the time that benefits become due, a pre-funded plan relies on an orderly schedule of contributions well in advance of benefit requirements. <u>The willingness and ability of the sponsor of a defined benefit pension plan to maintain an orderly schedule is a major factor in the benefit security for retirees and in the maintenance of an actuarially sound plan</u>. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they contain improper opinion testimony that is not rationally based on Mr. Lamoureux's perception and not helpful to clearly understand Mr. Lamoureux's testimony or to determine a fact in issue. FED. R. EVID. 701. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. Moreover, this is not a legal conclusion because it explains the basics of actuarial science, which the witness is more than qualified to testify about. |
| 18. The funded status is determined each year by comparing the assets in the plan to the liabilities of the plan. The assets are impacted by the | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at |

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| contributions received and investment returns on those contributions while the liabilities are impacted by the benefits earned by its employees, which is based on an employee's years of service and age of retirement. If the City does not timely make its required payments, the actuarial soundness of the fund may be negatively impacted. The actuarial calculations are premised on the fact that contributions will be made when required and invested when made. | 401, 402. | issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. This paragraph merely explains the consequences on the entire CalPERS system, from an actuarial standpoint, of what would happen in the event the City did not timely make is statutorily required payments to CalPERS. |
| 19. When contributions are delayed beyond the required date, the plan falls out of actuarial balance and actuarial soundness is put in jeopardy. By not making timely contributions, the asset base is not being increased as projected while at the same time, the liabilities are continuing to increase as employees continue to earn service credit. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | See Response to ¶ 18. |
| 20. An employer's contribution requirement is annually calculated and is expressed as a percentage of payroll. This may change due to presently considered modifications by the CalPERS Board. The employer's contribution amounts are due and payable following each pay period. Contributions are due by the 15th day following the last day in the pay period to which they relate. However, payroll and contribution information are due by the 30th day following the last day in the pay period to which they relate. Given this lag between the two dates, once CalPERS receives the payroll and contribution information, if there is any discrepancy between the amount paid and the payroll and contribution information supplied by the employer, later periodic payment amounts are adjusted to account for discrepancies. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. |

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| 21. An actuarial valuation for each plan of a contracting agency is performed every year to determine the present value of future benefits (i.e., the total amount of money needed to fully fund expected benefits for current members for both past and future service), the Normal Cost (which is the annual cost of one year of service accrual, as discussed above), the accrued liability (which is the value of benefits earned to date for past service only) and the current funded status (which is the market value of the assets as a percentage of the accrued liability). | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | See Response to ¶ 20. |
| 22. Every year, the employer contribution rate is adjusted based on the funded status. If the plan is less than 100% funded, the employer must pay both the Normal Cost and a payment towards the unfunded accrued liability. If the plan is 100% (or more) funded, the employer must only pay the Normal Cost. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | See Response to ¶ 20. |
| 23. To minimize the effect of any short-term market value fluctuations on employer contribution rates, CalPERS uses an asset smoothing technique where investment gains and losses are spread or "smoothed" over a period of time. On April 17, 2013, the CalPERS Board approved a recommendation to change the CalPERS amortization and rate smoothing policies. Ex. 5, Board of Administration, Public Employees Retirement System, *Resolution - Actuarial Policies - Amortization and Smoothing Policies* (April 17, 2013). Beginning with the June 30, 2013 valuations that set the 2015-2016 rates, CalPERS will no longer use an actuarial value of assets and will employ an amortization and smoothing policy that is designed to cover all gains and losses over a fixed 30-year period with the increases or decreases in the rate spread directly over a 5-year period. The new amortization and smoothing policy will be used for the | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | See Response to ¶ 20. |

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| first time in the June 30, 2013 actuarial valuations. These valuations will be performed in the fall of 2014 and will set employer contribution rates for the fiscal year 2015-2016. The advantage of the new method is that it will create less volatility in extreme years, quicker movement towards funded status and future contribution requirement will be more transparent. The unfunded liability component of the employer rates will increase in the short-term but in the long-term rates will decrease and the plan will be closer to attaining funded status. Ex. 9 (depicting contribution rates). | | |
| 24. The most recent Annual Valuation Reports prepared by CalPERS' actuaries for the City of Stockton were issued in October 2013, and provide valuations as of June 30, 2012. Ex. 6, CalPERS Actuarial Office, Safety Plan of the City of Stockton Annual Valuation Report as of June 30, 2012, (October 2013) ("Safety Valuation Report"); Ex. 7, CalPERS Actuarial Office, Miscellaneous Plan of the City of Stockton Annual Valuation Report as of June 30, 2012, at 28 (October 2013). In the course of preparing this declaration, I discovered an inaccuracy in the October Annual Valuation Report for the Miscellaneous Plan only with respect to the statement of the liabilities of the plan upon termination. I have corrected this inaccuracy and have posted an amended valuation report on the CalPERS website for the City of Stockton. Copies of the amended valuation report will be provided to the City and the parties in the bankruptcy case. My references to the valuation report for the miscellaneous plan in this declaration are to the amended report (the "Miscellaneous Valuation Report"). These reports:<br>Set forth the actuarial assets (including actuarial and market valuations) and accrued liabilities (including the | Franklin objects to the statements in this paragraph because Mr. Lamoureux's description of the Annual Valuation Reports is not the best evidence of those documents. FED. R. EVID. 1002. | As CalPERS' Deputy Chief Actuary, the witness is qualified to testify about the contents and calculations contained in the Valuation Reports. Moreover, the testimony explain an error the witness found and how and he corrected it. |

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| unfunded actuarial liability) of each plan as of June 30, 2012;<br>a. Determine the required Employer Contribution Rate for each plan for the fiscal year July 1, 2014 – June 30, 2015;<br>b. Provide actuarial information as of June 30, 2012, to the CalPERS Board of Administration and other interested parties; and<br>c. Provide pension information as of June 30, 2012, to be used in financial reports subject to Governmental Accounting Standards Board Statement 27 for a single employer defined benefit pension plan. | | |
| 25. In the most recent version of the Annual Valuation Reports, the actuarial valuations provide the following funding and rate information, for fiscal years 2012 and 2013:<br>a. The actuarial and market value of the assets;<br>b. The current unfunded liability; and<br>c. The funded ratio.<br>And for fiscal years 2013 and 2014, the reports provide projected employer and employee contribution rates for service credit earned during the applicable periods. | Franklin objects to the statements in this paragraph because Mr. Lamoureux's description of the Annual Valuation Reports is not the best evidence of those documents. FED. R. EVID. 1002. | See relevant portions of response to ¶ 24. |
| 27. The unfunded accrued actuarial liability calculation as described in the Annual Valuation Reports is not a reflection of any amounts that are currently owed by an employer, nor is it the amount that would need to be paid to fully fund a plan if the plan were to be terminated. Unfunded accrued actuarial liability as used in the Reports is a figure calculated to establish a funding target that is used for an ongoing plan that is a component of the actuarial calculation used to | Franklin objects to the statements in this paragraph because Mr. Lamoureux's description of the Annual Valuation Reports is not the best evidence of those documents. FED. R. EVID. 1002. Franklin further objects to the underlined statements in this paragraph because they contain improper opinion testimony that is not | See relevant portions of response to ¶ 24. In addition, as CalPERS' Deputy Chief Actuary, the witness is more than qualified to talk about contribution rates and their volatility. In fact, this testimony directly refutes Franklin's expert's testimony regarding the trajectory of contribution rates in |

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| determine the employer contribution rate for the upcoming fiscal year. <u>It is quite volatile and can 10 increase or decrease significantly over a relatively short period of time depending on, among other factors, the state of the economy and the health of the financial markets.</u> | rationally based on Mr. Lamoureux's perception and not helpful to clearly understand Mr. Lamoureux's testimony or to determine a fact in issue. FED. R. EVID. 701. | the future. |
| 28. The annual contribution is borne by both the employer and the employees. The future benefits for current employees will be assured only if all contributions of both employer and employee are made timely and in full. | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. |
| 29. In September 1944, the City of Stockton, through its City Council, elected to participate in the California State Retirement System, subject to the provisions of the State Employees' Retirement Act. Exs. 8.1, 8.2 (Stockton/CalPERS Original Contract & All Currently Applicable Amendments). The City's retirement plan has two subplans with different benefit formulas—safety employees and miscellaneous employees. Most City employees who are not safety employees are part of the miscellaneous subplan. | Franklin objects to the statements in this paragraph because Mr. Lamoureux's description of the contractual arrangement with CalPERS is not the best evidence of those documents. FED. R. EVID. 1002. | This testimony explains a historical fact and further explains CalPERS' understanding of it relationship with the City. |

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| 30. Under the PERL, a municipality elects to participate in the CalPERS system by entering into a "contract" with CalPERS in compliance with Chapter 5 of the PERL, Cal. Gov. Code §§ 20460 to 20593.[1] The PERL specifies in detail the provisions of the contract, the procedure by which a public agency may elect to participate, and many other terms. Once a city makes this statutory election, it is bound and controlled by the statutory provisions governing the system and the decisions of the CalPERS Board. Cal. Gov. Code § 20506 ("Any contract heretofore entered into shall subject the contracting agency and its employees to all provisions of this part and all amendments thereto . . ."). The governing statutes require the municipality to timely pay all required employer contributions. *Id.* §§ 20532, 20831. The PERL also prohibits the contracting agency from rejecting any contract pursuant to Section 365 of the Code. *Id.* § 20487. The statutory pension provisions are a fundamental part of the employment relationship, and should be read to require adequate funds to meet reasonable expectations of the employees. Participating cities cannot alter their funding obligation to CalPERS.<br><br>fn1. CalPERS will hand deliver to the Court a courtesy complete copy of the PERL for the convenience of the Court. | Franklin objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | See Response to ¶ 29. |
| 31. For this reason, the City's obligations to CalPERS are not limited to those found in the language of the document labeled a "contract"; rather, the City's obligations are defined primarily by applicable State law and regulations. | Franklin objects to the statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | See Response to ¶ 29. |

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| 34. <u>Stockton's employer contribution rates are relatively high compared with other cities in part because of the significant reduction in employees by Stockton during the past few years.</u> When layoffs occur, the contribution amount necessary to fund the unfunded liability remains basically unchanged as a result of the layoffs. Since contribution requirements are expressed as percentage of payroll, contribution rates will generally increase after layoffs even if there are no other changes and even if the amount due to pay off any unfunded liability has not changed. | Franklin objects to the underlined statements in this paragraph because they are speculative and lack foundation. FED. R. EVID. 602. Franklin further objects to the underlined statements in this paragraph because they contain improper opinion testimony that is not rationally based on Mr. Lamoureux's perception and not helpful to clearly understand Mr. Lamoureux's testimony or to determine a fact in issue. FED. R. EVID. 701. | As for foundation, as CalPERS' Deputy Chief Actuary the witness has more than adequate foundation to testify to the matters. Moreover, they are not improper opinion testimony because they are based on actuarial science and the witness personal understanding and knowledge. |
| 37. <u>Stockton's valuation results are similar in volatility to those of other California municipalities</u>. For all plans, volatility occurs when actuarial assumptions are not met. Volatility could come in the form of investment returns being higher or lower than expected and also in the form of members retiring earlier than anticipated, members living longer than assumed or members receiving larger salary increases than assumed. In any year, contribution requirements are as likely to either increase or decrease as a result of actual experience being different than assumed. If focusing on contribution rates instead of contribution amounts, hirings and layoffs, which are in the City's control, are a major driver of contribution rate volatility. Projected rates are based on payroll increasing at 3% per year. The rates included in the 2010 valuation were based on that assumption but, because payroll was lower a year later, CalPERS revised the rates upward to reflect the lower payroll and the higher rates necessary to generate the same amount of contributions toward the unfunded liability. The following year, the rates again increased to reflect the Board's changes to amortization. This year, CalPERS will once again revise | Franklin objects to the underlined statements in this paragraph because they are vague, speculative, and lack foundation. FED. R. EVID. 602. | See Response to ¶ 34. Moreover, given the witness's duties and responsibilities, this testimony is neither speculative nor vague because the witness has a working knowledge of CalPERS and its member agencies (i.e., employees) and contribution rates. |

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| the projected rates to reflect the change in actuarial assumptions adopted this February. It is not true that contribution rates constantly increase. <u>Contribution rates have declined for various reasons over the years and going forward they are as likely to either increase or decrease from their current projected levels.</u> | | |
| 38. The PERL allows for voluntary termination by a contracting agency and in certain circumstances, CalPERS may unilaterally terminate its relationship with a contracting agency. In the event of termination, a terminated agency is required to make a payment to CalPERS in an amount determined by the CalPERS Board (based on actuarial information) to be sufficient to ensure payment of all vested pension rights of the terminated agency's employees accrued through the termination date ("Termination Payment"). The Termination Payment goes into the "Terminated Agency Pool." Once the Termination Payment is made, CalPERS has no further recourse to a terminating employer. If a terminated agency the size of the City fails to pay the Termination Payment, benefits may have to be reduced pro rata based on the amount of the Termination Payment that is not funded. Once the terminated agency's assets and liabilities have been merged into the Terminated Agency Pool, no further benefit adjustments are permitted under the PERL. As a result, the pool is subject to actuarial risk. | Franklin objects to the statements in this paragraph because they contain improper legal conclusions. FED. R. EVID. 701. | This testimony is not an improper legal conclusion because it explains CalPERS' understanding of termination. |
| 40. A primary driver in determining the amount of the Termination Payment is the setting of the discount rate, which is a reflection of the asset policy or how the assets are invested. Given the conservative nature of the investments in the Terminated Agency Pool, the discount rate related to a Termination Payment is low when compared with the actuarial rate for the portfolio for | Franklin objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | See Response to ¶ 39. |

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| ongoing participating agencies. The cumulative effect of these policies is that a terminated agency's actuarial liability upon termination is larger than the actuarial liability on an ongoing basis.[2]<br><br><u>fn2. Furthermore, a terminating agency owes CalPERS the costs of collection, including attorneys' fees. Cal. Gov. Code § 20574.</u> | | |
| 41. Stockton's Annual Valuation Reports each provide a line item for "unfunded termination liability," which is an estimate of how much Stockton would owe to CalPERS if its contracts had been terminated as of *June 30, 2012*. The Miscellaneous Plan lists this unfunded termination liability at $575,931,065 and the Safety Plan lists this unfunded termination liability at $1,042,390,452, for a total of more than $1.6 billion. Exs. 6 & 7, Safety Valuation Report at 28 & Miscellaneous Valuation Report at 28. <u>If a terminated agency fails to pay the Termination Payment, benefits to employees must be reduced pro rata based on the amount of the Termination Payment that is not funded.[3] Cal. Gov. Code § 20577. CalPERS may reduce the benefits payable under the terminated contract only once. *Id.* After the terminated agency's assets and liabilities have been merged into the Terminated Agency Pool account, the PERL permits no further benefit adjustments. *Id.* § 20578.</u><br><br><u>fn3. CalPERS may choose to make no reduction or a lesser reduction if the CalPERS Board has made reasonable efforts to the collect the payment and the CalPERS Board determines that failure to make a reduction will not impact the actuarial soundness of the Terminated Agency Pool account. Cal. Gov. Code § 20577.5</u>. | Franklin objects to the statements in this paragraph because Mr. Lamoureux's description of the Annual Valuation Reports is not the best evidence of those documents. FED. R. EVID. 1002. Franklin objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | The witness is more than qualified to testify about the contents of the Valuation Reports. As for the second objection, again, this testimony explains CalPERS' understanding of what occurs in a termination. |
| 42. When a plan is terminated, the | Franklin objects to the | See Response to ¶ 41. In |

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| PERL imposes a lien in favor of CalPERS "on the assets of a terminated contracting agency, subject only to a prior lien for wages." Cal. Gov. Code § 20574. Legislative history confirms that this section immediately provides CalPERS with the rights of a senior secured creditor as a matter of law. The legislature expressly intended to "grant PERS a lien against the assets of public agencies who have terminated their membership in the system, usually as a result of agency dissolution and bankruptcy who have unfunded liabilities owed to PERS for vested employee benefits and have no ability to pay such liabilities." Ex. 13 at 35 (relevant portions of Legislative History of California Government Code § 20574). | statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | addition, the law says what it says and the Court can take judicial notice of the law and its legislative history. |
| 43. If Stockton chose to terminate its relationship with CalPERS, the City would be faced with an immediately due and owing massive termination liability secured by a senior lien on all its assets. The estimated combined unfunded termination liability for both of the City's plans as of 2012, net of the value of assets in the plans, is approximately $1.6 billion, as more particularly described in paragraph 41 above. | Franklin objects to the statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | This is not a legal conclusion, it is a fact based on the plain language of the applicable law. Moreover, the amounts owed upon termination are well within the witness's knowledge given he is CalPERS' Deputy Chief Actuary. |
| 44. I have read the "Reply of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund to the CalPERS Brief Regarding Pension Liabilities (the "Reply"). The Reply argues that a large portion of a termination claim "would not be an allowed claim because it would exceed the City's actual pension liability." Reply, 9:4-5. <u>That is not correct because, in a termination situation, the termination claim is the actual unfunded pension liability</u>. The Reply misapprehends the meaning of actuarial liability and the difference between an ongoing plan and a terminated plan. In an ongoing | Franklin objects to the statements in this paragraph because they misstate Franklin's arguments. Franklin objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. | First, this testimony does not misstate Franklin's arguments; in fact, it directly quotes Franklin's arguments. Second, the testimony merely corrects Franklin's fundamental misunderstanding regarding what the termination payment reflects. |

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| plan, adjustments can be made to future contributions as the actuarial results differ from actuarial assumptions and as assumptions change over time. In a terminated plan, there are no future contributions and no ability to make adjustments. <u>Consequently, the actuarial liability for a terminated plan is necessarily greater than the actuarial liability for an ongoing plan, and the unfunded actuarial liability on termination is the amount that would be needed to fully fund the plan because there will be no further contributions and would therefore be the amount of the claim.</u> | | |
| 45. <u>In a termination, CalPERS would continue benefits without reduction only if the Board were to find that benefit continuation will not impact the actuarial soundness of the Terminated Agency Pool. Cal. Gov. Code § 20577.5.</u> *As a result, because Stockton could not fund its shortfall following a hypothetical termination, in the event that Stockton did not fund a material amount of its contribution obligations, CalPERS would be required to reduce benefits before merging Stockton's assets into the Terminated Agency Pool.* | Franklin objects to the underlined statements in this paragraph because they are improper legal conclusions. FED. R. EVID. 701. Franklin objects to the italicized statements in this paragraph because they speculative and lack foundation. FED. R. EVID. 602. | The underlined statement is not a legal conclusion because it explains CalPERS' understanding of what might occur upon termination. Moreover, it is not speculative because it explains what CalPERS would do in the event of an unfunded termination. |
| 46. Further, if the City chooses to terminate its relationship with CalPERS, the City could not enter into a new relationship with CalPERS for at least three years from the date of termination. *Id*. § 20460. Although the City's existing employees that had benefits accrued as of the termination date in CalPERS would retain their benefits (albeit likely reduced dramatically), they would earn no additional benefits, and new employees would have no retirement system in which to participate. | Franklin objects to the statements in this paragraph because they contain improper legal conclusions. FED. R. EVID. 701. | Again, this is not a legal conclusion; rather, it is a statement on the consequences of termination and explains CalPERS' understanding of the consequences of such termination. |
| 47. Generally, benefits accrued by an employee while working for one agency participating in CalPERS are | Franklin objects to the statements in this paragraph because they contain | See Response to ¶ 46. |

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| portable should that employee move to another CalPERS participating employer. This is also true for employers who enjoy reciprocity with CalPERS. This means that benefits will continue to accrue uninterrupted when an employee transfers to another employer albeit under the benefits formulas and other ancillary benefits provided for under employment agreements for each employer during the time of service for that employer. Each agency will bear responsibility for payment for the benefits accrued during the service of the employee. For example, for an employee who works for Stockton for fifteen years and then works for the City of Davis for five years, the benefits will be funded by Stockton for the fifteen year period and by Davis for the five year period. If the Stockton plan were to be terminated, the benefits for Stockton employees would likely be reduced for the period of their service with Stockton if Stockton failed to pay a substantial portion of its termination liability. For employees that transfer to another employer that was also part of the CalPERS system, they would continue to accrue benefits that would not be subject to reduction on account of the termination of the Stockton plans. | improper legal conclusions. FED. R. EVID. 701. | |
| 48. CalPERS' principal responsibility is to maintain the integrity of the California Public Employees' Retirement System. The ability of the sponsor of a defined benefit pension plan to maintain an orderly and reliable schedule of benefit payments is the principal factor in providing benefit security for retirees and in the maintenance of an actuarially sound plan. If a City like Stockton does not timely make its required payments, the actuarial soundness of the fund will be negatively impacted. The actuarial calculations are premised on the assumption that contributions will be | Franklin objects to the statements in this paragraph because they are not relevant. FED. R. EVID. 401, 402. Franklin further objects to the underlined statements in this paragraph because they are speculative and lack foundation. FED. R. EVID. 602. | Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This testimony explains who CalPERS is and is therefore relevant under Franklin's theory of the case. Moreover, as CalPERS' Deputy Chief Actuary, the witness is more than qualified to testify about these matters. Moreover, the statements are not speculative because they |

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| made when required and invested when made. When contributions are delayed beyond the required date, the plan falls out of actuarial balance and actuarial soundness is put in jeopardy. By not making timely contributions, the asset base is not being increased as projected while at the same time, the liabilities are continuing to increase as employees continue to earn service credit. <u>No contracting agency can be allowed to unilaterally determine when and how much it will contribute to fulfill its obligations to the retirement system. Allowing such a unilateral modification of contribution obligations threatens the integrity of the retirement systems and the interests of the State of California in the administration of benefits for its public servants.</u> | | reflect reality. |

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| Exhibit No. 1 – July 2011 Paper Titled "Vested Rights of CalPERS Members" – pp. 1-20 | Franklin objects to this exhibit because it contains legal conclusions and Mr. Lamoureux is not qualified to confirm whether the legal interpretations contained in this exhibit are correct. FED. R. EVID. 701. Franklin further objects to this exhibit for the reasons set forth in its impending *Objections Of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund To CalPERS' Supplemental Exhibit List For Evidentiary Hearing Regarding Confirmation Of Proposed Plan Of Adjustment*. | CalPERS and Franklin have already agreed to withdraw their respective objections to the introduction of this Exhibit. |
| Exhibit No. 9 – Graph Depicting Rates Over Time for Sample Miscellaneous Plant – p. 346 | Franklin objects to this exhibit because it lacks foundation. FED. E. EVID. 602. Franklin further objects to this exhibit because it is irrelevant. FED. R. EVID. 401, 402. Franklin further objects to this exhibit because it poses an incomplete hypothetical. Franklin further objects to this exhibit for the reasons set forth in its impending *Objections Of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund To CalPERS' Supplemental Exhibit List For Evidentiary Hearing Regarding Confirmation Of Proposed Plan Of Adjustment*. | This Exhibit is a portion of a PowerPoint that the witness himself created and therefore he has foundation to testify about it contents.<br><br>Franklin, not CalPERS nor the City, have put the relationship between CalPERS and the City at issue in this case. This Exhibit directly contradicts Franklin's expert's erroneous view about the trajectory of contribution rates.<br><br>Moreover, it is not an incomplete hypothetical because it explains historical rates. |

Respectfully submitted,

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Dated: May 9, 2014

By: */s/ Michael K. Ryan*
Michael K. Ryan

Attorneys for California Public Employees' Retirement System