

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE BOARD OF TRUSTEES OF
THE PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

In the Matter of the PERA Salary
Determinations Affecting Retired and
Active Employees of the City of Duluth

**FINDINGS OF FACT,
CONCLUSIONS
AND RECOMMENDATION**

Allen Johnson, et al., Petitioners

Administrative Law Judge Bruce H. Johnson (the ALJ) conducted a hearing in this consolidated contested case proceeding on Thursday, September 30, 2010, and continuing on Thursday, October 14, 2010, in the Duluth City Council Chamber, third floor, Duluth City Hall, 411 West First Street, Duluth, MN 55802. The hearing followed the consolidation of seventy Notices and Orders for Pre-Hearing Conferences and Hearings (Notices of Hearing) issued by the PERA Board of Trustees (PERA Board) on July 10, 2009. OAH hearing record closed with the receipt of all of the parties' post-hearing briefs on December 17, 2010.

Carla Heyl, Assistant Attorney General,¹ appeared on behalf of the staff of the Staff of the Public Employees Retirement Association (PERA or PERA Staff). Elizabeth Storaasli, Storaasli, Knutson & Pommerville, Ltd., appeared on behalf of a group of Petitioners, all retired Duluth firefighters (Represented Petitioners).² Petitioner Bryan F. Brown, Attorney at Law, appears *pro se*, as do the remaining Petitioners in this proceeding (Unrepresented Petitioners).

STATEMENT OF ISSUES

In the Notices of Hearing the PERA Board requested the ALJ to make findings of fact, conclusions, and recommendations on the following issues:³

1. Are amounts paid by the City of Duluth under the terms of applicable collective bargaining agreements between the City and its employees

¹ Ms. Heyl was substituted for Assistant Attorney Jon K. Murphy as counsel for the PERA Staff after the earlier proceedings on the parties' cross-motions for summary disposition.

² Specifically, Petitioners Paul Ostman, Doug Michog, John Edwards, Mark Behning, Terry Purcell, Doug Belanger, Dave Salvesson, Anne Peterson, L. J. Harvey, William L. Johnson, and Dave Wedin.

³ In the Summary, Conclusions, and Memorandum that follow, the ALJ found it more convenient to address the issues raised by the Board in a somewhat different order than the order in which they were presented in the Notices of Hearing.

which are characterized as “insurance supplement payments” salary for PERA purposes?

2. Does the cash-out of “personal leave days” under the terms of the applicable collective bargaining agreements constitute salary for PERA purposes?

3. Are amounts paid by the City of Duluth to an employee’s deferred compensation account salary for PERA purposes?

4. Is PERA barred from taking action to recover overpayments or reduce future benefits based upon any applicable statute of limitations?

5. Is PERA barred from taking action to recover overpayments or reduce future benefits based upon promissory estoppel or any other related claim of reliance?

6. Is it reasonable for PERA to rely upon the records submitted by the City of Duluth to make its benefit adjustments?

The ALJ also addressed the following issues that were raised during the course of the contested case proceedings:

7. Is PERA barred from taking action to recover overpayments or reduce future benefits from City employees because some or all of its interpretations of Minn. Stat. § 353.01, subd. 10,⁴ were interpretive rules, which were not formally adopted as such and which were not exempt from adoption as long standing interpretations?

8. If City employees paid federal and state income taxes on the City’s insurance supplement and deferred compensation payments at the time when those payments were made, are those payments then salary for PERA purposes?

SUMMARY

By stipulation of the parties, cashed-out “personal leave days” under the terms of the applicable collective bargaining agreements constitute salary for PERA purposes, and that determination is effective retroactively and applies to all City firefighters, currently employed or retired, regardless of whether or not they were parties to the Settlement Agreement.

The City did not take action to exercise an option granted to it by the legislature to limit the ability of PERA to correct errors attributable to incorrect eligible wage determinations so long as PERA’s salary adjustments were in process as of May 23, 2009. PERA is therefore not barred by any statute of limitations from taking action to

⁴ Except where otherwise indicated, all references to Minnesota Statutes are to the 2009 Supplement.

recover overpayments or reduce future benefits. PERA is also not barred by the doctrines of promissory or equitable estoppel from taking action to recover overpayments or reduce future benefits.

PERA's interpretation that the City's contributions to family-dependent hospital-medical premiums are excluded from PERA salary simply reflects the plain meaning of the statute. It is therefore not an interpretive rule. On the other hand, Minn. Stat. § 353.01, subd. 10, is ambiguous about whether employer-paid deferred compensation must be excluded from PERA salary. PERA's interpretation that the statute excludes such payments from treatment as PERA salary is an interpretive rule which has never been formally adopted pursuant to Minn. Stat. ch. 14 and which does not qualify as a long standing interpretation. PERA cannot therefore apply that interpretation to the Petitioners and other City employees and use it in recalculating their retirement benefits, contributions, and overpayments.

Nevertheless, looking forward, the ALJ concludes that PERA's interpretation that Minn. Stat. § 353.01, subd. 10(b)(2), correctly resolves the ambiguity of whether employer-paid deferred compensation must be excluded from PERA salary, and that amounts paid by the City deferred compensation on which income taxes are actually deferred are "fringe benefits" within the meaning of Minn. Stat. § 353.01, subd. 10(b)(2) are therefore excludable from PERA salary.

Additionally, payments made by the City for employee deferred compensation are salary for PERA purposes if City employees paid federal and state income taxes on those payments at the time when the payments were made. A preponderance of the evidence established that the City deferred compensation payments were frequently taxed as income when those payments were made. Whenever that occurred, those payments were no longer excludable fringe benefits but rather became current wages. For that reason alone, PERA must again recalculate the retirement benefits of City employees using more accurate information and estimates of PERA salary.

It is not reasonable for PERA to rely upon the records the City submitted to PERA for the purpose of making benefit adjustments because those records included many deferred compensation payments on which employees paid state and federal income taxes at the time when those payments were made. Payment of income taxes at that time, in effect, converted those payments from excludable fringe benefits into current wages. Although there may be significant difficulties involved with arriving at reasonable estimates of PERA salary for some periods, those difficulties are not insurmountable, and should place the burden of arriving at more reasonable estimates on the City, which is statutorily required to provide PERA with accurate reports of employee salary.

Based upon all of the proceedings herein, the Administrative Law Judge makes the following:

FINDINGS OF FACT

Prior Proceedings

1. On March 12, 2009, the PERA staff sent written notices to approximately 485 current and former City employees. The notices informed the recipients that PERA Staff had determined that the City had erroneously reported certain amounts paid to them between 1997 and 2008 as being “salary” for purposes of calculating retirement plan contributions and benefits.⁵ Those notices informed the employees that if they disagreed with PERA’s salary eligibility determinations, they could file Petitions for Review by filling out and submitting a form that PERA enclosed with the letters.⁶

2. Subsequently, seventy of the current and retired City employees who received those letter notifications filed Petitions for Review.⁷

3. Thereafter, by action taken on May 14, 2009, the PERA Board of Trustees referred those seventy matters to the Office of Administrative Hearings (OAH) for the initiation of contested case proceedings pursuant to Minn. Stat. § 356.96, subd. 12(b).

4. On July 10, 2009, the PERA Staff issued seventy Notices and Orders for Pre-Hearing Conference and Hearing (Notices of Hearing) in OAH Docket Numbers 4-3600-20751-5 through 4-3600-20820-5. The Notices of Hearing scheduled a prehearing conference before the ALJ on August 21, 2009, at the Duluth City Hall, 411 West First Street, Duluth, Minnesota 55802.⁸

5. On August 13, 2009, the PERA Staff filed a Petition for Consolidation of all seventy pending contested case proceedings—namely, OAH Docket Nos. 4-3600-20751-5 through 4-3600-20820-5, inclusive.

6. The ALJ convened the prehearing conference at the Duluth City Hall on August 21, 2009. The ALJ issued a Pre-Hearing Order on August 26, 2009, which addressed the following matters:

a. Finding that all seventy contested case proceedings involved common questions of law and possibly common questions of fact, the ALJ ordered them consolidated for that purpose. They were also consolidated for purposes of discovery and the filing and disposition of any dispositive motions.

⁵ Copies of the notification letters sent to each of the seventy named Petitioners, as well as the Petitions for Review that each of them subsequently sent to PERA were attached to the respective Notices and Orders for Pre-Hearing Conferences and Hearings. The letter notification sent to Petitioner Allen Johnson and the Petition for Review that he submitted are representative of those documents, and for ease of reference, the ALJ has included them as Hearing Exhibits 18 and 19. See Ex. 18.

⁶ *Id.*

⁷ See Ex. 19.

⁸ All subsequent hearings were conducted at the same location, hereafter referred to as the “Duluth City Hall.”

b. The ALJ granted PERA leave to add similarly situated current or retired City employees as parties to the consolidated proceeding by initiating separate contested case proceedings and serving those parties with notices of hearing. However, PERA stated for the record that upon final adjudication of the issues, it planned to accord City employees who had not filed Petitions for Review the same treatment as those who had filed Petitions for Review. PERA therefore indicated that it was unlikely that it would seek to add additional parties.

c. The ALJ ordered that any petitions for intervention must comply with Minn. R. 1400.6200 and must be filed and served on or before Friday, September 11, 2009.

d. The ALJ directed that all discovery, including responses or objections to timely requests for written discovery and depositions, to be completed on or before November 30, 2009, and that any dispositive motions and responses be filed by Friday, January 15, 2010.

e. Finally, the ALJ allowed parties to accept service by email.

7. No Petitions to Intervene were received by September 11, 2009.

8. On that date, the Represented Petitioners filed a motion for compulsory joinder of the City as a necessary party. PERA filed objections to that motion on September 30, 2009. By Order issued on October 20, 2009, the ALJ denied the motion for compulsory joinder of the City, concluding that the ALJ lacked jurisdiction to order the City's participation as a party. The ALJ concluded that any issues raised by Petitioners regarding their contractual relationships with the City were beyond the scope of this proceeding.

9. On October 8, 2009, the ALJ issued a Protective Order limiting disclosure of information protected by Minn. Stat. Ch. 13.

10. On November 19, 2009, seven active City firefighters filed a motion for summary disposition asserting that compensation, which those firefighters had been receiving from the City at the end of each year representing the value of personal leave they had not taken during the year, did qualify as "salary" for purposes of calculating their PERA benefits.

11. Thereafter, on January 5, 2010, those seven firefighters, PERA, and the Represented Petitioners all entered into a Settlement Agreement, under which PERA agreed and stipulated that payments for unused personal leave days, which were made pursuant to applicable collective bargaining agreements, would be considered "salary" under Minn. Stat. § 353.01, subd. 10. PERA further agreed that that determination would be retroactive and would also apply to all City firefighters currently employed or retired, regardless of whether or not they were parties to the Settlement Agreement.

12. On December 2, 2009, the Represented Petitioners filed a motion to compel the City to produce documents that the Represented Petitioners were seeking to obtain from the City under subpoena. They also requested recovery of attorney's fees from the City and an extension of the deadlines for conducting discovery and filing dispositive motions. By Order issued on January 7, 2010, the ALJ denied the motion to enforce the subpoena because Minn. Stat. § 14.51 vests exclusive enforcement of subpoenas in district court. Because the City was not a party, the ALJ also denied the motion to compel discovery. However, the ALJ did grant the motion to extend discovery until February 1, 2010, and to extend the deadline for dispositive motions until March 1, 2010.

13. On December 31, 2009, PERA moved for summary disposition on all remaining issues. It contended that certain employer paid deferred compensation contributions and insurance supplement payments were "salary" within the meaning of Minn. Stat. § 353.01, subd. 10. It likewise maintained that neither a statute of limitations nor any available equitable remedy barred PERA from making commensurate adjustments to the Petitioners' past or future benefits. PERA filed a memorandum of law and several affidavits in support of its motion.⁹

14. On February 15, 2010, the Represented Petitioners also moved for a summary disposition. They, too, filed a memorandum of law and several affidavits in support of their motion and in opposition to PERA's motion for summary disposition. Petitioner Bryan F. Brown, Attorney at Law, appearing *pro se*, also filed a motion for summary disposition. Mr. Brown's motion incorporated the Petitioner's Memorandum by reference. On March 16, 2010, PERA filed a memorandum in opposition to the Represented Petitioners' motion for summary disposition.¹⁰

15. On April 13, 2010, the ALJ conducted a hearing on the pending motions for summary disposition at which counsel for the represented parties, as well as some Petitioners appearing *pro se*, presented oral argument. At the close of that hearing, the ALJ allowed the parties to supplement the record with post-hearing submissions relating to certain specific issues addressed during oral argument. On April 20, 2010, both PERA and the Represented Parties filed post-hearing submissions.¹¹

16. By Order issued on May 20, 2010, the ALJ re-opened discovery until July 16, 2010. Discovery was reopened for the sole purpose of allowing the parties to further develop the record regarding the income tax treatment of amounts paid by the City of Duluth to the Petitioners' deferred compensation plans or family health insurance

⁹ See PERA's Memorandum in Support of Motion for Summary Disposition dated Dec. 31, 2009. During the October 14, 2010, hearing, the ALJ incorporated that memorandum into the OAH hearing record. All of PERA's supporting affidavits were received as hearing exhibits.

¹⁰ See Petitioner's Memorandum in Support of Motion for Summary Disposition dated Feb. 17, 2010, and PERA's Response in Opposition to Petitioner's Motion for Summary Judgment dated Mar. 16, 2010. The ALJ also incorporated both of those memoranda into the OAH hearing record, and all of the Represented Petitioners' supporting affidavits were received as hearing exhibits.

¹¹ PERA's letter of April 20, 2010 (PERA Submiss.) and the Represented Petitioners' letter of April 20, 2010 (Pet. Submiss.), respectively.

plans during the period 1995 through September 2008. The ALJ retained the pending motions for summary disposition under advisement pending submission by the parties of further evidence pertaining to that issue.

17. Between May 20 and July 16, 2010, the Represented Petitioners and PERA supplemented the record with additional information regarding the tax treatment of amounts that the City paid on the Petitioners' behalf for deferred compensation accounts and family medical insurance. On July 21, 2010, after considering all of the evidence in the record, the ALJ concluded that a genuine issue of disputed fact existed regarding the City's tax treatment of the payments in dispute. Accordingly, by Order issued the ALJ denied all of the pending motions for summary disposition.

18. On August 11, 2010, the ALJ issued an Order scheduling an evidentiary hearing in this proceeding beginning for Thursday, September 30, 2010, at the Duluth City Hall. The Order stated that the hearing would be limited to presentation of evidence regarding the tax treatment of amounts that the City paid on the Petitioners' behalf for deferred compensation accounts or for family medical insurance during the period 1995 through September 2008. However, by letter to the parties dated September 23, 2010, the ALJ noted that a ruling had not yet been made on the issue of whether application of the doctrine of equitable estoppel prevents PERA from adjusting the benefits of, or recovering overpayments from, the Petitioners. The ALJ therefore invited the parties to supplement the evidentiary record relating to that issue if they wished to do so.

19. During the hearing on September 30, 2010, the parties tendered their hearing exhibits and presented the testimony of several witnesses. However, one of PERA's witnesses, City Auditor Wayne Parson, was out of the state and therefore did not respond to the subpoena that had been issued to him. The ALJ therefore adjourned the hearing until Thursday, October 14, 2010, for the purpose of taking Mr. Parson's testimony.

20. The evidentiary hearing reconvened on Thursday, October 14, 2010, and counsel proceeded with the direct and cross-examination of Mr. Parson. The ALJ also allowed unrepresented Petitioner, Pamela Wutz, to present her sworn statement.

21. Exhibits 1 through 20 and 101 through 131 have been received as evidence.

22. The OAH hearing record closed on December 17, 2010, when all of the parties' post-hearing briefs were submitted.

Background

23. PERA manages and administers pension plans for public employees, including the PERA "general" plan (General Plan) and the PERA Police and Fire Plan (P & F Plan). Minnesota Statutes chapters 353, 356 and 356A govern the administration of those plans, which are "governmental plans" pursuant to federal law. The PERA retirement plans therefore have tax-deferred or "qualified" status, for both

federal and state income tax purposes, meaning that the contributions to these plans and the income generated from those contributions are tax deferred until the benefits are actually distributed to the employee.¹² It is only then that taxable events occur with respect to benefit payments to employees.

24. The amount of retirement benefits to which an individual is entitled for PERA purposes is determined by a formula utilizing years of services multiplied by a percentage factor for each year of service, times the employee's "high five" salary.¹³

25. Minn. Stat. § 353.01, subd. 10(a), defines "salary" for purposes of calculating PERA benefits. Subdivision 10(b) of that section describes amounts to be excluded from salary for those purposes. Governmental subdivisions participating in PERA are responsible for reporting "salary" and the correct employer and employee PERA contributions.¹⁴

26. The City is a governmental subdivision of the state within the meaning of Minn. Stat. § 353.01, subd. 6(a), and is therefore an employer that participates in PERA's retirement program. As such, City employees, whose salary exceeds \$425 in any month and who are not specifically excluded by statute or who have not declined optional participation, must participate in the PERA General Plan or the P & F Plan, as appropriate.¹⁵

27. Minn. Stat. § 353.27, subd. 4, requires the City to remit to PERA the aggregate amount of the required employee and employer contributions within 14 calendar days after each pay date. PERA accepts the salary reports of participating employers at face value and assumes that they correctly reflect applicable law.¹⁶

28. During the period from 1995 through 2008, City employees in five different bargaining units participated in PERA General and P & F Plans. Those bargaining units were the City of Duluth Supervisory Association (the CDSA), the City of Duluth Confidential Employees (the CDCE), the Duluth Police Union, Local 807 (Duluth Police Union), AFSCME Council 5, Local 66 (AFSCME), and Local 101 of the International Association of Firefighters (IAFF).¹⁷

29. The Petitioners are current or former City employees and were members of the CDSA, the CDCE, the Police Union, AFSCME, or the IAFF during the period from 1995 through 2008.¹⁸

¹² See *AFSCME Council 614, 65 and 96, AFL-CIO v. Sundquist*, 338 N.W.2d 560, 565 (Minn. 1983), *appeal dismissed*, 466 U.S. 9, 22 104 S. Ct. 1902 (1984).

¹³ Minn. Stat. § 353.01, subd. 17(a).

¹⁴ Minn. Stat. § 353.27, subd. 4.

¹⁵ Minn. Stat. § 353.01, subd. 2a(a).

¹⁶ Tr. pp. 149-50, 169.

¹⁷ Ex. 13, ¶ 3.

¹⁸ See Notices of Hearing in OAH Docket Numbers 4-3600-20751-5 through 4-3600-20820-5, inclusive.

Legislative History of Minn. Stat. § 353.01, Subd. 10(a) and (b)

30. The Legislature created the “public employes retirement association” in 1931 for the purpose of creating and administering retirement and disability benefit programs for “public employees,” whom the act identified as employees and appointive and elective officers of counties, cities, villages, and school districts.¹⁹ Those benefit programs were funded by three and one-half percent (3 ½%) contributions by those employees “of his or her regular salary.”²⁰ As originally enacted, the legislation did not include a definition of “salary.”²¹

31. In 1933, the legislature amended the definitions section of the 1931 act to include a Section 9, Paragraph 2, which set forth the following definition of “salary”:

‘Salary’ shall mean the periodical compensation of any public employee and shall also be deemed to mean ‘wages,’ and in the case of officers elected to fee office, shall be deemed to include fees.²²

Although placed in quotations, like the definitions in the amendment, the legislature did not define “wages.”²³

32. In 1941, PERA’s governing legislation was recodified as Minn. Stat. ch. 353. However, the 1933 definition of salary remained unchanged in the new Minn. Stat. § 353.01, subd. 10.²⁴

33. Between 1941 and 1973, additional amendments were made to Minn. Stat. § 353.01, subd. 10. In 1973, the legislature deleted some language from that subdivision that post-1941 amendments had added. It also inserted the following phrase that expanded the definition of “salary:”

‘Salary’ means the periodical compensation of any public employee, before deductions for deferred compensation or supplemental retirement plans, and also means “wages” and includes net income from fees.²⁵

34. In 1974, the legislature began adding language to Minn. Stat. § 353.01, subd. 10, describing amounts excluded from the definition of “salary.”²⁶ In 1988 it enacted an amendment that inserted yet another phrase that further expanded the definition of salary”:

¹⁹ Act of April 24, 1931, ch. 307, sec. 1, 1931 Minn. Laws 617-618.

²⁰ *Id.* at sec. 4.

²¹ *Id.* at sec. 1.

²² Act of April 21, 1933, ch. 374, sec. 1, 1933 Minn. Laws 389-98.

²³ In fact, the term “wages” has remained in all successive versions of 1931 Minn. Laws ch. 307 but has never been defined.

²⁴ See codification reference in Act of March 9, 1945, ch. 78, sec. 1, 1945 Minn. Laws 112.

²⁵ Act of May 24, 1973, ch. 753, sec. 8, 1973 Minn. Laws 2266, 2272.

²⁶ See Act of March 23, 1974, ch. 229, sec. 3, 1974 Minn. Laws 343, 346.

'Salary' means the periodical compensation of ~~any a~~ a public employee, before deductions for deferred compensation ~~or~~ or supplemental retirement plans, or other voluntary salary reduction programs, and also means "wages" and includes net income from fees.²⁷

35. No material changes to Minn. Stat. § 353.01's definition of salary occurred until 1991 when Minn. Stat. § 353.01, Subd. 10(a) and (b) were amended to provide:

Subd. 10. **Salary.** (a) 'Salary' means the periodical compensation of a public employee, before deductions for deferred compensation, supplemental retirement plans, or other voluntary reduction programs, and also means "wages" and includes net income from fees. Fees paid to district court reporters are not salary. Unused annual or sick leave payments, in lump sum or periodic payments, are not salary. Severance payments, workers' compensation payments, and all payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage, are not salary. Before the time that all sick leave has been used, amounts paid to an employee under a disability insurance policy or program where the employer paid the premiums are salary, and, after all sick leave has been used, the payment is not salary.

(b) Except as provided in sections 353.86 or 353.87, compensation of any kind paid to volunteer ambulance service personnel or volunteer firefighters, as defined in subdivisions 325 and 36, is not salary.²⁸

36. In 1993, the legislature amended and reorganized Minn. Stat. § 353.01, subd. 10(a) and (b), for the purpose of defining in paragraph (a) everything that salary *included* and defining in paragraph (b) everything that salary *excluded*.²⁹ "Employer-paid flexible spending accounts" and "cafeteria plans" became statutory exclusions for the first time. "Fringe benefits" were not yet excluded. As amended, that section provided:

Subd. 10. **Salary.** (a) 'Salary' means the periodical compensation of a public employee, before deductions for deferred compensation, supplemental retirement plans, or other voluntary reduction programs, and also means "wages" and includes net income from fees.

(b) Salary does not mean fees paid to district court reporters, unused annual or sick leave payments, in lump-sum or periodic payments, severance payments, reimbursement of expenses, lump-sum settlements not attached to a specific earnings period, or workers' compensation payments. Salary does not mean employer-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care

²⁷ See Act of May 4, 1988, ch. 709, art. 5, sec. 1, 1988 Minn. Laws, 1609, 1612-1613.

²⁸ See Act of May 31, 1991, ch. 341, sec 3, 1991 Minn. Laws 2525, 2528-29.

²⁹ See Act of May 17, 1993, ch. 307, art. 4, sec. 7, 1993 Minn. Laws 1747, 1753-54.

expenses, or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage.

37. In 1994, the legislature again amended Minn. Stat. § 353.01, subd. 10(b). This time “employer-paid fringe benefits” were also explicitly listed as a statutory exclusion for the first time. As amended, the statute provided:

(b) Salary does not mean:

(1) fees paid to district court reporters, unused annual or sick leave payments, in lump-sum or periodic payments, severance payments, reimbursement of expenses, lump-sum settlements not attached to a specific earnings period, or workers' compensation payments;

(2) employer-paid amounts used by an employee toward the cost of insurance coverage, employer-paid fringe benefits, flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage- and certain amounts determined by the executive director to be ineligible;³⁰

38. In 2008, the legislature enacted Minn. Stat. § 353.01, subd. 10, in its current form.³¹ It provides in relevant part:

(a) Subject to the limitations of section 356.611, "salary" means:

(1) the periodic compensation of a public employee, before deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs, and also means "wages" and includes net income from fees;

(2) for a public employee who is covered by a supplemental retirement plan under section 356.24, subdivision 1, clause (8), (9), or (10), which require all plan contributions be made by the employer, the contribution to the applicable supplemental retirement plan when an agreement between the parties establishes that the contribution will either result in a mandatory reduction of employees' wages through payroll withholdings, or be made in lieu of an amount that would otherwise be paid as wages;

* * *

(b) Salary does not mean:

³⁰ See Act of April 26, 1994, ch. 528, art. 2, sec. 1, 1994 Minn. Laws 659, 671. The 1994 amendment also split Minn. Stat. §353.01, subd. 10(a) into subparagraphs (1) and (2), with subparagraph (1) containing the language previously set forth in Minn. Stat. §353.01, subd. 10(a) and with subparagraph (2) containing provisions not relevant to this proceeding.

³¹ See Act of May 27, 2008, ch. 349, art. 5, sec. 15, 2008 Minn. Laws 1483, 1514-15.

(1) the fees paid to district court reporters, unused annual vacation or sick leave payments, in lump-sum or periodic payments, severance payments, reimbursement of expenses, lump-sum settlements not attached to a specific earnings period, or workers' compensation payments,³² * * *

(2) employer-paid amounts used by an employee toward the cost of insurance coverage, employer-paid fringe benefits, flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage and certain amounts determined by the executive director to be ineligible.

* * *

The 1994 Legislative Study Committee

39. The 1994 legislature enacted the following legislation establishing a Salary Study Committee to recommend changes to definitions of "salary" in state public pension statutes:

In an effort to treat public employees in a fair and equitable manner and to protect the financial integrity of the public pension plans, the legislative commission on pensions and retirement shall establish an advisory committee to study the definitions of salary in chapters 353, 354, and 354A to determine the high-five average consecutive years of salary component for the formula used to calculate retirement annuities and disability benefits.

The advisory committee must be composed of at least three executive directors and executive secretaries of the seven public pension plans, and the chair, vice-chair, and executive director of the pension commission.

The advisory committee shall report its findings and recommendations to the pension commission by February 15, 1995.³³

40. That Salary Study Committee was duly constituted and included a representative of PERA. The Committee subsequently submitted a report containing, among other things, the following:

The committee identified several salary issues that were treated differently by certain funds:

- 1) Employer matching contributions to the Deferred Compensation Program (MSRS)

Committee Recommendation: Should not be included as salary. Generally, employer contributions are not considered salary, stopping deductions on employer paid deferred compensation amount would be consistent with this philosophy.

³² The 2008 language of relevant portions of the subdivision remains in effect.

³³ Act of April 26, 1994, ch. 538, art. 1, sec 13, subd. 2, 1994 Minn. Laws 669, 675-76, codified as Minn. Stat. § 356.88, subd. 2 (1994).

* * *

In compliance with the Laws of Minnesota, Chapter 528, Article 1, Section 13, Subdivision 2, the committee offers this report, and requests passage of the attached law which will put into law the committee's recommendations.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

Section 1. Minnesota Statutes 1994, section 352.01, subdivision 13, is amended to read:

Subd. 13 **SALARY.** 'Salary' means the periodical compensation paid to any employee before deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs. It also means wages and includes net income from fees. Lump sum sick leave payments, severance payments, lump sum annual leave payments and overtime payments made at the time of separation from state service, payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to an employee with single coverage, and payments made as an employer-paid fringe benefit ~~and~~, workers' compensation payments, employer contributions to a deferred compensation or tax sheltered annuity program, and amounts contributed under a benevolent vacation and sick leave donation program are not salary.³⁴

41. Thereafter, the 1995 legislature enacted the following amendment to Minn. Stat. § 352.01, subd. 13:

~~'Salary' means the periodical wages, or other periodic compensation, paid to any an employee before any deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs. It also means wages and includes net income from fees. Lump sum sick leave payments, severance payments, lump sum annual leave payments and overtime payments made at the time of separation from state service, payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to an employee with single coverage, and payments made as an employer-paid fringe benefit and, workers' compensation payments, employer contributions to a deferred compensation or tax sheltered annuity program, and amounts contributed under a benevolent vacation and sick leave donation program are not salary.~~³⁵

³⁴ Ex. 20 (at Ex. A).

³⁵ See Act of May 30, 1995, ch. 262, art. 1, sec. 3, 1995 Minn. Laws 2818, 2819-20.

42. Since at least 1994, PERA has neither proposed nor sought an amendment specifically excluding employer contributions to deferred compensation accounts from the definition of “salary” in Minn. Stat. § 353.01, subd. 10(b).³⁶

43. Minn. Stat. § 352.01, subd. 13, is the only state retirement system legislation containing that specific salary exclusion.

44. Minn. Stat. § 354.05, subd. 35, defines “salary” for purposes of calculating disability and retirement benefits obtainable by teachers and other employees covered by the Teachers Retirement Association (TRA). A 1989 amendment to that subdivision first excluded from treatment as salary:

employer-paid amounts used by an employee toward the cost of insurance coverage, employer-paid fringe benefits, flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage;³⁷

45. In 1992, the Executive Director of the TRA issued a letter advising all of the state’s school districts that “employer matching contributions to deferred compensation programs “are not eligible as salary for TRA purposes and TRA deductions should not be withheld from them.”³⁸

History of PERA’s Application of Minn. Stat. §353.01, subd. 10

46. Since before 1995 and continuing to the present, PERA’s Executive Director has interpreted Minn. Stat. §353.01, subd. 10, as excluding employer-paid deferred compensation from treatment as salary for purposes of calculating PERA retirement and disability benefits.³⁹

47. The July 1, 1993, edition of *PERA’s Reporting Manual for Payroll and Personnel Officers* stated, among other things, that:

PERA contributions are to be made from total (gross) salary before deducting deferred compensation or supplemental retirement plans, or other voluntary reductions in salary.

That manual also identified that “Salary Subject to PERA Withholding” included, among other things, “[e]mployee-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount that reduces the employee’s salary.” It further identified that “Salary Not Subject to PERA Withholding” included, among other things, “[e]mployer-paid flexible spending accounts, cafeteria plans, health

³⁶ Ex. 20, ¶11.

³⁷ Minn. Stat. § 354.05, subd. 35(b)(3).

³⁸ Ex. 9.

³⁹ Ex. 14 and Ex. 20.

care expense accounts, day care expenses, or an amount paid to an employee to pay for insurance premiums that is in addition to the employee's regular salary."⁴⁰

48. The April 1994 edition of *PERA "Phrase"* stated, among other things, that:⁴¹

In most cases, an employee's entire gross earnings are considered eligible for PERA deductions. This is salary before deductions for deferred compensation, supplemental retirement plans and other voluntary reductions in salary.

Gross salary includes an employee's regular wages, overtime earnings, compensatory time, holiday pay, retroactive wage settlements, merit increases and pay for **used** vacation.

There are, however, some types of compensation which are not considered eligible for PERA deductions and should not be reported on your Salary Deduction Report. These include, but are not limited to, unused sick leave and vacation pay, severance pay, retirement incentive pay, retirement bonuses and lump-sum settlements not attached to specific earnings periods. Also excluded are compensation for incurred employee expenses (either in advance or as reimbursement), workers' compensation, long- or short-term disability insurance payments, jury duty pay and charges assessed for personal use of a government vehicle. Finally, any employer-paid portions of flexible spending accounts is not considered salary for PERA purposes.

The table below lists compensation to employees which is and is not PERA deductible

Salary

Earning, wages and overtime

* * *

The **employee-paid** portion of flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses or any amount that reduces the employee's salary

(Not) Salary

* * *

All **employer-paid** portions of flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses or an amount paid to an employee to pay for insurance premiums that is in addition to the employee's regular salary

All payments made to an employee in lieu of employer-paid group insurance including the difference between single and family rates

⁴⁰ Ex. 129 (at Ex. E-1).

⁴¹ Ex. 129 (at Ex. E-5).

49. The August 1994 edition of *PERA "Phrase"* stated, among other things, that:⁴²

It is sometimes difficult to determine which employee earnings are eligible for PERA withholding and which are not. While association deductions are to be taken from gross salary, there are some exceptions to that general rule that are designed to ensure all PERA members receive equal treatment when it come time to calculate their pensions.

Recently, PERA has found many employers reporting contributions that are not subject to association withholdings. By law, some forms of compensation must not be reported.

PERA withholdings cannot be made on any amount that represents:

* * *

- Employer-paid flexible spending accounts;

* * *

In addition to these categories of compensation, the 1994 Minnesota Legislature further clarified several other forms of earnings that are not to be reported as salary to the association:

- Employer-paid amounts used by an employee toward:
- The cost of insurance coverage;
- Employer-paid fringe benefits;
- Cafeteria plans;
- Health Care expense accounts;
- Day care expenses;
- Any payment in lieu of any employer-paid group insurance coverage (including the difference between single and family rates that may be paid to a member with single coverage);

* * *

AND

- Certain amounts determined by PERA's executive director to be ineligible.

* * *

50. The January 1995 edition of *PERA "Phrase"* stated, among other things, that:⁴³

Salary *Subject to PERA Withholding* Is:

- Earning, wages, overtime and compensatory pay
- * * *
- Employee-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount that reduces the employee's salary.

⁴² Ex. 129 (at Ex. E-5).

⁴³ Ex. 129 (at Ex. E-5).

* * *

Salary Not Subject to PERA Withholding Is:

* * *

- Employer-paid fringe benefits, flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage
- Employer-paid amounts used by an employee toward the cost of insurance coverage.

* * *

51. The April 1, 1996, edition of *PERA's Reporting Manual for Payroll and Personnel Officers* stated, among other things, that:

Generally, PERA-eligible earnings are considered gross salary and are paid to employees for labor performed or services rendered. PERA contributions are to be made from total (gross) salary before deducting deferred compensation as defined by Section 457 of the IRS Code, supplemental retirement plans, or other voluntary reductions in salary.

That manual also identified that "Salary Subject to PERA Withholding" included, among other things, "[e]mployee-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount that reduces the employee's salary." It further identified that "Salary Not Subject to PERA Withholding" included, among other things, "[e]mployer-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount paid to an employee to pay for insurance premiums that is in addition to the employee's regular salary." It also identified "employer-paid amounts to be used by an employee toward the cost of insurance coverage."⁴⁴

52. The September 1999 edition of the *PERA Employer Manual* stated, among other things, that:

The following lists identify earning that are and are not subject to PERA withholding. While we have tried to be as thorough as possible, the list is not comprehensive. An employer should contact PERA for assistance if there are questions about whether a type of payment is or is not eligible for PERA deductions.

⁴⁴ Ex. 129 (at Ex. E-2).

Salary Subject to PERA Withholding

- Employee-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount that voluntarily reduces the employee's salary.

* * *

Salary Not Subject to PERA Withholding

- Employer-paid flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments instead of employer-paid insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage.
- Employer-paid amounts paid directly to and used by an employee toward the cost of insurance coverage.⁴⁵

* * *

53. The July 2002 edition of the *PERA Employer Manual* stated, among other things, that:

Below is a list of some of the types of salary payments that are subject to PERA withholding. The list is not meant to be all-inclusive. If you have questions about any payment type, whether listed below or not, please contact PERA.

- Gross earnings, wages, and overtime pay for services performed in an eligible position during the coverage period being reported. Gross earnings must include compensation treated as deferred income for federal or state income taxation or both.

* * *

- Employee-paid amounts to flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or an amount that voluntarily reduces the employee's salary. Often these amounts are not treated as income for federal taxation under Internal Revenue Code.

* * *

By law, some forms of compensation are not subject to PERA deductions and must not be reported as salary. PERA withholding cannot be made on the following forms of compensation. Again, this list is not all-inclusive. If you have any questions, please contact PERA.

⁴⁵ Ex. 129 (at Ex. E-3).

- Employer-paid amounts to flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments instead of employer-paid insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage.

* * *

- Employer-paid amounts paid directly to an employee to be used toward the cost of insurance coverage regardless of whether the individual uses the full amount for insurance coverage or receives cash for any unused allowance.⁴⁶

54. In 1992, the City of St. Paul informally requested an opinion from PERA staff on whether an employer contribution to deferred compensation is considered eligible earnings for PERA.⁴⁷ PERA's response to St. Paul's request is not included in the record.

55. On June 16, 2004, Teddi Hayes, an accountant employed by the City of St. Paul, requested the following advice in an email message to Bruce Marietta of the PERA staff:

I decided to request in writing a determination on whether an employer contribution to deferred compensation is considered eligible earnings for PERA.

In the Employer Handbook under 'Salary not subject to PERA Withholding' there is a paragraph that states Employer-paid benefits....Deferred compensation is not specifically mentioned.⁴⁸

56. Mr. Marietta wrote the following handwritten comment on a copy of the email that he received from Hayes:

Martin—

You have an opinion?

Just seems like a standard employer deferred comp. match and not PERA-eligible to me.

Thanks

Bruce⁴⁹

57. By letter dated June 25, 2004, Mr. Marietta stated the following in response to Mr. Hayes' earlier email message:

⁴⁶ Ex. 129 (at Ex. E-4).

⁴⁷ T. pp. 137, 141-42. Ms. Keating's testimony regarding that 1992 inquiry was based solely on her recollection; she was unable to find documentation in PERA's files to support how and when that inquiry was made.

⁴⁸ Ex. 8.

⁴⁹ Ex. 8.

After reviewing the information that you provided concerning the deferred compensation match established in the labor agreement between the City and Locals 120, 49, and 132, we find that our decision is the same as a previous response dated May 19, 1992 (copy enclosed).⁵⁰

58. After PERA initiated this proceeding, PERA staff obtained information that amounts paid by other public employers, including the City of Virginia, Minnesota, the Western Lake Superior Sanitary District (WLSSD), and the Duluth School District (Independent School District 709), may also have made payments to their employees that fall within Minn. Stat. § 353.01, subd. 10(b) exclusions from PERA salary, as the PERA staff interpret those exclusions.⁵¹

59. Although deferred compensation is not specifically mentioned in the Employer Manual—under the section titled “Salary Not Subject to PERA Withholding— PERA considers employer-paid amounts to deferred compensation plans as payments ineligible for PERA withholdings regardless of whether the employer payments are processed through the City’s payroll system.⁵²

60. The Legislative Auditor’s Financial Statement Audit of PERA for the year ending June 30, 2009, contained the following finding and recommendation:

Prior Finding Not Resolved: PERA did not have adequate controls to ensure that employers reported and remitted the correct amount of salaries and retirement contributions.

PERA did not have control procedures in place to ensure employers reported amounts based on statutory requirements. This internal control weakness increased the risk of pension contributions and retirement benefits being overstated or understated.

In our audit report for the year ended June 30, 2008, we noted that the City of Duluth had erroneously reported employee salaries to PERA dating back to January 1997. The city had incorrectly included some employer-paid benefits in its calculation of employees’ base salaries. The city used this overstated salary amount to determine both its employee and employer retirement contributions and also reported these incorrect base salaries to PERA. PERA used the incorrect base salaries to determine employees’ pension benefits.

Employers are responsible to report members’ eligible salaries in accordance with Minnesota Statutes. According to the statute, employer-paid fringe benefits, including employer contributions to flexible spending accounts, deferred compensation plans, and insurance coverage, are excluded from the definition of salary. Although PERA provided extensive

⁵⁰ Ex. 7 (A copy of PERA’s May 19, 1992, correspondence was not attached to Ex. 7).

⁵¹ Tr. p. 137.

⁵² Ex. 7. A copy of PERA’s May 19, 1992 correspondence was not attached to Ex. 7.

training to employers on how to calculate and report salary information and pension contributions, it did not verify that employers reported the correct base salaries and pension contributions.

Recommendation

- *PERA should verify that participating employers properly calculate and report eligible salaries and contributions.*

61. By letter dated March 3, 2010, PERA submitted the following response to the Legislative Auditor's finding and recommendation:

Response: We have system controls in place that ensure the contributions we receive are calculated correctly based on the salary provided, but we have not had the authority in statute to conduct compliance audits. We have had an extensive training program that includes online information, employer handbooks, quarterly newsletters and training sessions throughout the state, and have introduced legislation that would give us authority to "establish reporting procedures and methods as required to review compliance by employers with the salary and contribution reporting requirements..." Should the legislation pass, we will be allowed to review payroll records of participating employers.

We have been working with the Teachers Retirement Association to jointly plan compliance audits of schools once we have authority in statute to do so. We will work with them for the next couple of years on schools, then will broaden our scope to include other employers. During this past year we also restructured the work done by staff so that we could free up the time of two employees to handle compliance audits.⁵³

62. Over the years, PERA has published numerous documents meant to provide guidance to its constituents regarding what should or should not be included as salary for PERA benefit purposes. The only reference those documents have made to "deferred compensation," has been to Minn. Stat. § 353.01, subd. 10(a)'s reference to "deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs." None of those documents have specifically identified employer deferred compensation payments as a form of compensation not includable in salary for PERA purposes.⁵⁴ PERA has also never generally issued guidance or expressed the position to its participating employers or members that payments made by a public employer to be directed to employee deferred compensation plans do not constitute salary for purposes of calculating PERA benefits.

63. Unlike the TRA,⁵⁵ PERA has never issued written guidance to all of its participating employers explicitly advising them of PERA's interpretation that Minn. Stat.

⁵³ Ex. 20 (at Ex. B).

⁵⁴ Ex. 129 (at Exs. E-1 through E-7).

⁵⁵ See Finding 43, *supra*.

§ 353.01, subd. 10, excludes employer-paid deferred compensation from treatment as PERA salary.

64. Minn. Stat. § 353.18, provides in relevant part that “[a]ll matters and administrative details not specifically provided for in this chapter shall be governed by rules issued and promulgated by the board of trustees.” PERA therefore has authority to adopt rules containing its interpretations of the provisions of Minn. Stat. § 353.01, subd. 10(b) but has never exercised that authority.⁵⁶

The City’s Compliance with Minn. Stat. § 356.25

65. As a governmental subdivision, the City’s contribution of public funds to deferred compensation plans is addressed in statutes other than Minn. Stat. § 353.01. For example, Minn. Stat. § 356.24, subd. 1, provides in pertinent part:

It is unlawful for a school district or other governmental subdivision or state agency to levy taxes for or to contribute public funds to a supplemental pension or deferred compensation plan that is established, maintained, and operated in addition to a primary pension program for the benefit of the governmental subdivision employees.

The subdivision goes on to enumerate fourteen exceptions to that prohibition, none of which are germane to this proceeding.

66. Minn. Stat. § 356.25 provides in pertinent part:

Notwithstanding any other provision of law or charter to the contrary, no city, county, public agency or instrumentality, or other political subdivision is required or permitted to establish for any of its employees a local pension plan or fund financed in whole or in part from public funds, other than:

(1) a supplemental pension or deferred compensation plan authorized under section 356.24;

67. The State Auditor performs annual audits of the City’s finances, which include specific, separate payroll audits.⁵⁷ Because the State Auditor’s staff works year-round to complete the audit, they have been given space in Duluth’s City Hall. A portion of the audit of the City’s payroll practices involves randomly selecting at least twenty-five payroll checks during the year being audited and comparing them with the applicable W-4 form, time cards, employee authorizations for any deductions, and other supporting documentation.⁵⁸

68. In a follow-up note to the audit for the year ending December 31, 2001, the State Auditor noted that the deferred compensation provisions in the Collective

⁵⁶ Tr. pp. 163-64.

⁵⁷ Ex. 112, ¶ 1; Ex.131, ¶ 11.

⁵⁸ Ex. 112, ¶11.

Bargaining Agreements (CBAs) might violate Minn. Stat. § 356.24, which “restricts the amount an employer can contribute, the plan that can be contributed to and what purposes those contributions are for.” The note went on to state that “[i]t appears that the contributions made by the City are not in compliance with this statute.”⁵⁹ However, the City’s copy of that audit note includes the hand-written note, “Resolved.”⁶⁰

69. The audit note was considered “resolved” when Les Bass, who was then City Auditor, and Jackie Morris, who was then Manager of Payroll/Personnel Systems, both discussed the issue with the State Auditor’s staff in 2001. Both recalled that the State Auditor’s Office focused on the questions of whether the deferred compensation payments were included as income and whether matching payments were required. When the City informed the State Auditor’s staff that the City’s payments were included in the employees’ gross wages and that no employee match was required, the State Auditor listed the issue as “resolved.”⁶¹

70. In its annual audits of the City, the State Auditor’s Office did not address whether the City’s payments to employee deferred compensation plans or for family insurance coverage properly was considered salary for PERA reporting purposes.⁶²

City Employee Deferred Compensation Plan and Insurance Benefits

71. Between 1995 and 2008, City employees participated in deferred compensation plans underwritten by Hartford, Minnesota Mutual, Great West and other insurance companies. All were Section 457 plans, meaning that they qualified under section 457 of the Internal Revenue Code. Prior to retirement, the payments could be withdrawn by employees, subject to a penalty and taxes. The employees could also draw on those amounts as loans.⁶³

72. Between 1995 and 2008, the City did not make any third-party medical insurance or health insurance products available to its employees. Rather, the City maintained a self-insured medical expense fund for employees—that is, the City transferred funds out of its general fund into a special fund reserved for the payment of claims.⁶⁴ Payment of claims was administered by a third-party claims administrator. Each year the City established the cost of employee and family coverage based on the prior year’s claims experience. The City itself fully funded the cost of its employees’ coverage. If employees elected to do so, they paid the full additional cost of family coverage, by paying an annual family coverage premium.⁶⁵

73. The City protected itself against the loss that would occur if employee medical cost claims exceeded the amount placed annually in the city’s special reserve

⁵⁹ Ex. 129 (at Ex. B); *see also* Ex. 108, ¶ 6 and attachments.

⁶⁰ *Id.*

⁶¹ Ex. 108, ¶ 6; Ex. 111, ¶ 1. *See also* Ex. 112, ¶ 10; Ex. 131, ¶ 11.

⁶² Tr. p. 362.

⁶³ Ex. 111, ¶ 9; *see also* 26 U.S.C. § 457.

⁶⁴ Ex. 108, ¶ 7; Ex. 130, ¶ 2. On occasions, the City Council apparently allowed the City to maintain a negative fund balance. *See* Exs. 108 and 112.

⁶⁵ Exs. 108, ¶ 9; Ex. 111, ¶ 12; Ex. 130, ¶¶ 2-4.

fund by purchasing a re-insurance product, called “stop loss insurance,” that indemnified the City against an overage of claims that exceeded 110 percent of the projected amount of claims for the year.⁶⁶

74. Family medical insurance coverage became progressively more expensive, and fewer City employees opted to direct the City payments described in Findings 73 through 80, below, to family medical insurance coverage. Also, as the coverage became more expensive, more employees opted out and provided family coverage through programs available to spouses or by purchasing coverage in the private insurance market.⁶⁷ This exodus, in turn, further increased the premiums for family coverage for employees who continued coverage by the City.

The City’s Collective Bargaining Agreement from 1995 through 2008

75. In 1994, during contract negotiations between the City of Duluth and its Supervisors’ Association (CDSA), the City offered the CDSA a payment toward deferred compensation in lieu of a salary increase because of the City’s reluctance to perpetuate a “compounding effect of a percentage increase on subsequent negotiations.”⁶⁸ That offer was accepted by the CDSA,⁶⁹ and Article 12 of the 1995–1996 Collective Bargaining Agreement (CBA) between the City and the CDSA included the following provision:

12.1 The employer shall allow an employee to participate in any deferred compensation plan of the employee’s choice which meets the following criteria:

- a. It has been approved by the deferred compensation commission.
- b. It qualifies under the laws and regulations of the United States, State of Minnesota, Internal Revenue Service.
- c. The employer can accomplish any record keeping, data processing, accounting, or administration of the plan by making a reasonable effort.

The employer shall not do any act to change, alter, amend or terminate any employee’s deferred compensation plan without first giving at least sixty (60) days’ written notice of its intention, and completing the processing of any grievance brought concerning the proposed action, unless law, ruling or order of the Internal Revenue Service requires it.

Beginning January 1, 1995, the employer shall contribute \$25 each month to any employee’s deferred compensation plan which exists pursuant to

⁶⁶ Ex. 130, ¶ 2.

⁶⁷ Ex. 108, ¶ 9.

⁶⁸ Ex. 131, ¶ 2.

⁶⁹ *Id.*

this article. Beginning January 1, 1996, the amount of the employer's contribution shall be increased to a sum of \$50 each month.⁷⁰

76. Article 12 of the 1997-1999 CBA between the City and the CDSA contained essentially the same language as the 1995–1996 CBA, except that it increased the monthly contribution to \$75 per month in 1997, \$100 per month in 1998 and \$125 per month in 1999. The CBA also provided covered employees with the option of using that sum either as a “contribution to a qualifying and approved deferred compensation plan, or for contribution to family-dependent hospital-medical premium, whichever is designated by the employee during the open window for insurance selection, or at the time of a life event.”⁷¹

77. In the 2000-2002 CBA, the amounts of the City's payments continued to increase until the benefit was \$224 per month (plus an additional \$5 per month for employees enrolled in “plan 3 hospital-medical insurance”) for either deferred compensation or toward family-dependent hospital-medical premiums.⁷² These amounts remained the same through 2006 and increased to a flat \$229 per month in the 2007-2009 CBA between the City and the CDSA.⁷³

78. From 1997 through 2008, the CBAs between the City and the IAFF included the same provisions for employer payments to deferred compensation plans or toward the cost of family-dependent hospital-medical premiums in the same amounts as the provisions in the City's CBAs with the CDSA.⁷⁴

79. From 1997 through 2008, the CBAs between the City and the Duluth Police Union included the same provisions for employer payments to deferred compensation plans or toward the cost of family-dependent hospital-medical premiums as the provisions in the City's CBAs with the CDSA.⁷⁵ However, the amounts of the City's payments were slightly lower from 1997 through 2006, and beginning in 2007 the amount of the payments dropped to \$75 per month.

80. CBAs between the City and the CDCE during this time period included similar provisions for employer payments to deferred compensation plans or toward the cost of family-dependent hospital-medical premiums as the provisions in the City's CBAs with the CDSA, but the amounts were different, starting at \$75 per month in 1997 and increasing ultimately to \$245 per month in the 2007-2009 CBA.⁷⁶

81. From 1995 through 2008, the CBAs between the City and AFSCME included the same provisions for employer payments to deferred compensation plans or

⁷⁰ Ex. 13 (at Ex. 5f); Ex. 129 (at Ex. A).

⁷¹ Ex. 13 at (Ex. 5e).

⁷² *Id.* at (Ex. 5d).

⁷³ *Id.* (at Exs. 5a through 5c).

⁷⁴ *Id.* (at Exs. 1a through 1e).

⁷⁵ *Id.* (at Exs. 3a through 3g).

⁷⁶ *Id.* (at Exs. 4a through 4g).

toward the cost of family-dependent hospital-medical premiums in the same amounts as the provisions in the City's CBAs with the CDSA.⁷⁷

82. With the exception of the first CBA between the City and the CDSA, all subsequent CBAs between the City and its bargaining units permitted employees to choose between the deferred compensation and the insurance payment options. During the years when the City's CBAs provided for those payments, most employees chose to direct the funds into deferred compensation plans.⁷⁸

The City's Treatment of the Bargained Payments as PERA Salary

83. When the City was negotiating its 1995-1996 CBA with the CDSA, John Hall, the President of the CDSA, asked Karl Nollenberger, who was the City's Chief Administrative Officer and who was negotiating the contract for the City, whether the payments for either deferred compensation or family medical coverage that the City was offering would be considered salary for purposes of PERA. "[O]n more than one occasion," Nollenberger assured Hall that the payments would be considered salary.⁷⁹

84. When the deferred compensation payments by the City first became a part of the City's CBAs, the City Auditor's staff worked directly with PERA staff to determine how to handle those payments in the City's payroll system.⁸⁰ The deferred compensation payments were included in employees' gross salary as part of total compensation and subject to social security tax. The deferred compensation payments made by the City, together with any employee contributions were both shown on paystubs as deductions. PERA staff advised the City to include its deferred compensation payments "in employees' gross salary as part of total compensation and subject to social security tax."⁸¹

85. During the labor negotiations that occurred between 1995 and 2008, the City advised members of its bargaining units that City payments to them for either deferred compensation or family medical coverage would be considered salary for purposes of PERA.⁸²

Discovery and Reporting of Apparent City PERA Contribution Errors

86. Wayne Parson has been the Duluth City Auditor since May 2005. In that capacity, he oversees all of the City's accounting functions including accounts payable, financial reporting, and processing the biweekly payroll for City employees. Before becoming City Auditor, Mr. Parson was employed for twenty-three years as an auditor in the State Auditor's Office. In that capacity he was assigned to the State Auditor's

⁷⁷ *Id.* (at Exs. 2a through 2f).

⁷⁸ Ex. 111 at ¶ 12.

⁷⁹ Ex. 131, ¶¶ 2, 3 and 5.

⁸⁰ Exs. 108, ¶ 4; Ex. 111, ¶ 2.

⁸¹ Ex. 108, ¶ 4.

⁸² Ex. 101, ¶ 3;

Duluth Office, which was responsible for performing audits of the political subdivisions in northeastern Minnesota, including the City of Duluth.⁸³

87. On July 21, 2007, while Mr. Parson was reviewing the final paycheck of an employee who had recently resigned, he noticed that the City was paying an employer contribution to PERA on a payment made to the employee for the bargained insurance supplement. Mr. Parson considered that to be odd and he contacted Chris Arcand of the PERA staff to ascertain whether the City's payments for employee deferred compensation and family insurance supplement were considered to be PERA-eligible earnings.⁸⁴

88. Subsequently, on July 31, 2007, Mr. Parson followed up by sending the following e-mail message to Mr. Arcand:

Please see attachments. My interpretation of the information under 'Salary not Subject to PERA Withholding' in the PERA Employer Manual is that these employer paid benefits are not PERA salary and accordingly employee and employer PERA contributions should not be withheld/paid.⁸⁵

89. Mr. Arcand replied that he agreed with Mr. Parson "that these are employer paid benefits, not employee-paid benefits 'that voluntarily reduce[d] the employee's salary.' Therefore they would not be eligible for PERA contributions."⁸⁶

90. Mr. Parson advised his supervisor, Genie Stark, who was then the City's Finance Director, that there was a problem with the financial data that the City was reporting to PERA.⁸⁷ He subsequently stated to then City Administrator John Hall, that the deferred compensation payments were "not in compliance."⁸⁸ At that time, Mr. Hall was uncertain about what Mr. Parsons meant about the payments not being "in compliance."⁸⁹

91. In August 2007, Mr. Parson told Jackie Morris, then the City's Payroll Coordinator and Manager of Payroll/Personnel Systems, that the City was incorrectly reporting its payments to employee deferred compensation plans to PERA.⁹⁰

92. Ms. Morris believed that Mr. Parson's opinion about PERA treatment of the City's deferred compensation payments was incorrect, and she phoned PERA to

⁸³ Tr. pp. 258-60.

⁸⁴ Tr. pp. 260, 266, 347.

⁸⁵ Ex. 14, (at Ex. 8); Tr. p. 261.

⁸⁶ *Id.*

⁸⁷ Tr. p. 343.

⁸⁸ Ex. 131, ¶ 12; Tr. p. 261.

⁸⁹ *Id.*

⁹⁰ Ex. 111, at ¶ 14.

obtain clarification. The individual whom she consulted at PERA agreed that the City's deferred compensation payments should be treated as PERA salary.⁹¹

93. Nevertheless, on or about August 1, 2007, Mr. Parson, on his own initiative, directed Ms. Morris to stop reporting the City's deferred compensation/family medical coverage payments to PERA as part of salary.⁹² Mr. Parson communicated that decision to Finance Director Genie Stark.⁹³ That decision was not communicated to PERA, any other City official, or the City's employees or retirees.⁹⁴

94. Thereafter, between August 1, 2007, and September 15, 2008, neither Mr. Parson nor any other City official investigated further to determine the extent of the City's apparent non-compliance with PERA policies.⁹⁵ During the same period no one on the PERA staff followed up with the City to obtain further information on the extent of the City's apparent non-compliance.⁹⁶

95. After August 1, 2007, and through most of 2008, PERA continued to send out retirement annuity estimates to City employees that were based on PERA salary information, which continued to include the City's deferred compensation/family medical insurance payments.⁹⁷ During that period, PERA also held retirement seminars for, and provided telephonic retirement advice to, City employees during which PERA made no mention of potential recalculations of the retirement benefits.⁹⁸

96. It was not until September 2008 that the issue of the City's apparent non-compliance with PERA's policies on reporting of salary resurfaced. In September 2008, Mr. Parson had a meeting with Lisa Potswald, who had recently replaced Mr. Hall as the City's Chief Administrative Officer,⁹⁹ during which Ms. Potswald expressed her concerns about the number of errors that were occurring in the City's payroll system. She asked Mr. Parson about errors that had occurred in the past, including the issues that had been raised with PERA in July 2007.¹⁰⁰

97. On September 15, 2008, Ms. Potswald, with Mr. Parson's assistance, sent a letter to Mary Most Vanek, PERA's Executive Director, informing Ms. Vanek "about an error made by the City ... in the treatment of certain employer-paid benefits as salary subject to PERA taxes."¹⁰¹ In her letter, Ms. Potswald referred to the payments only as "insurance supplement payments"; she did not refer to any of the payments as being for deferred compensation. The letter stated "[o]ur annual financial statement audit

⁹¹ *Id.*; Tr. pp. 348-49.

⁹² Ex. 111, ¶ 14; Tr. 349-50, 349-50.

⁹³ Tr. 353-54.

⁹⁴ Tr. p. 356-57.

⁹⁵ Tr. p. 266.

⁹⁶ Tr. pp. 172, 180.

⁹⁷ Ex. 125, ¶¶ 3, 7.

⁹⁸ Tr. pp. 146-147.

⁹⁹ Mr. Hall retired on April 28, 2008. Ex. 131, ¶ 1.

¹⁰⁰ Tr. pp. 266-67.

¹⁰¹ Ex. 129 (at Ex. E-19); Tr. pp. 262-63.

conducted by the Office of the State Auditor did not detect this error.” Ms. Potswald directed Ms. Vanek to Mr. Parson for answers to any follow-up questions.¹⁰²

98. On September 18, 2008, PERA asked the City to provide payroll information back to 2005 so that contributions to PERA could be audited and recalculated.¹⁰³

99. On September 19, 2008, Mr. Parson emailed a number of City documents to Mr. Arcand, along with a request to “direct any inquiries regarding this issue directly to me and not to our payroll office.”¹⁰⁴

100. On October 8, 2008, Mr. Parson wrote a letter to Mr. Arcand of the PERA staff stating:

I am writing to confirm the information required by PERA for refunding tax overpayments made by the City of Duluth for certain employer paid benefits that were erroneously reported as salary subject to PERA taxes. My analysis indicates \$5,857,244.87 was erroneously reported as salary subject to PERA taxes for the years 2005, 2006 & 2007 and my estimate of the PERA taxes overpaid during this time period is \$761,907.46. Additional PERA tax overpayments were made in years prior to 2005. However, the availability of payroll records to ascertain the amounts erroneously reported as salary subject to PERA taxes has not yet been confirmed.

My understanding of our discussions is that I will provide you with a listing of these employer paid benefits by calendar year, by employee, including the employee’s social security number in an Excel spreadsheet format. The amount listed for each employee will represent the total payments to that employee for a given calendar year. These employer paid benefits were paid in equal amounts over twenty-six pay periods per calendar year (bi-weekly payroll cycle). These employer paid benefits vary depending on the language in the various city bargaining agreements.

My understanding is PERA will calculate the amount of tax overpayments based upon the information submitted by the City referred to above. PERA will then refund the tax overpayments to the City and will identify the portion of the refund that represents the employee contributions. The City will then be responsible for processing refunds for employee contributions to these employees including the withholding of applicable state and federal income taxes.

¹⁰² *Id.*

¹⁰³ Ex. 111, ¶ 15 and attachment; Ex. 123, ¶ 11; Ex. 3.

¹⁰⁴ Ex. 14; Ex. 127; Tr. pp. 365.

The City continues to investigate payroll records prior to 2005 and will make a second tax overpayment submission to PERA at a later date, depending on the information available.¹⁰⁵

101. The City subsequently reported to PERA information from City payroll records that were still available the amounts of City-paid deferred compensation and insurance supplement payments it had made to each of the City's employees during the period from 2005 through September 18, 2008.

102. When the City reported the amounts of City-paid deferred compensation payments and insurance supplement payments it had made to each of the City's employees from 2005 through September 2008, it did not advise PERA that some of those payments were included in employees' taxable income at the time those payments were made.¹⁰⁶

The City's Income Tax Treatment of the Bargained-For Payments

103. Employer and employee contributions to a deferred compensation plan are not subject to federal and state income tax at the time those contributions are made. Rather, compensation that is deferred is subject to income tax when the benefits are later distributed to the employee.¹⁰⁷

104. The City does not presently withhold any federal or state income tax for its employees from the amounts that the City pays them for employer-paid deferred compensation or for the employer-paid insurance supplement.¹⁰⁸

105. Larry Kroll is a *summa cum laude* graduate of the University of Minnesota-Duluth with a B.A degree in accounting and business administration. He was an active Certified Public Accountant (CPA) from approximately 1972 until 2003, when he asked to be placed on inactive status. From 1981 to 2003, Mr. Kroll was employed as Finance Director of Douglas County, Wisconsin, and in that capacity placed government payroll systems in operation¹⁰⁹

106. Mr. Kroll was engaged to analyze payroll and tax documents that Petitioner Arthur Zylka received while employed by the City of Duluth. Mr. Kroll was given all of Mr. Zylka's paycheck stubs and W-2 statements for part of 2000 and all of 2001, 2002, and 2003. Mr. Zylka no longer had any check stubs for 1997, 1998, and 1999, although he had W-2 statements for those years.¹¹⁰ Mr. Kroll then proceeded to

¹⁰⁵ Ex. 127.

¹⁰⁶ Tr. p. 348. The evidence did not establish when the City provided PERA with data about the amounts City-paid deferred compensation and insurance supplement payments made during the period 1995 through December 31, 2004.

¹⁰⁷ Tr. pp. 135.

¹⁰⁸ Tr. pp. 269-70.

¹⁰⁹ Tr. pp. 43-46.

¹¹⁰ Tr. pp. 48.

conduct an analysis that reconciled the amounts indicated on Mr. Zylka's 2001, 2002, and 2003 paystubs with his W-2 statements for those years.¹¹¹

107. Based on his analysis, it is Mr. Kroll's opinion that during tax years 2001, 2002, and 2003, the City's contributions to Mr. Zylka's deferred compensation plan were treated by the City's payroll system as current taxable wages for federal and state income tax purposes and were not accounted for as employer contributions to Mr. Zylka's deferred compensation plan.¹¹² In other words, the City accounted for those payments in its payroll system in the same way as it accounted for salary increases based on longevity.¹¹³ Moreover, there was nothing in the payroll stubs and W-2 statements that Mr. Kroll examined to document that the City ever directed its deferred compensation payments to Mr. Zylka's Section 457 deferred compensation plan.¹¹⁴

108. It was Mr. Kroll's further opinion that the City's payments to Mr. Zylka as insurance supplements to reduce the cost of family medical coverage, which were made during the same period, were also treated by the City's payroll system as current taxable wages for federal and state income tax purposes and were not accounted for as pre-tax benefits.¹¹⁵

109. Based on the City's income tax treatment of the payments described in Findings 105 and 106, it is Mr. Kroll's opinion that the amounts that the City reported to PERA as current salary during the during tax years 2001, 2002, and 2003 were correct.¹¹⁶

110. Although Mr. Kroll did not conduct the same kind of analysis of paystubs and tax documents received in evidence for other Petitioners. Nevertheless, from Mr. Kroll's examination of some of the other Petitioners' paystubs it appeared that the City had prepared those paystubs and tax documents in the same way it had prepared Mr. Zylka's paystubs and tax documents.¹¹⁷

111. It is the opinion of Mr. Parson that PERA salary should reflect employees' taxable income.¹¹⁸

112. Because of payroll entry errors made in several pay periods from 1995 through December 31, 2004,¹¹⁹ some or all of the total deferred compensation contributions for some City employees, were taxed as current wages when the contributions were made and those contributions were therefore not tax-deferred.¹²⁰

¹¹¹ Ex. 120.

¹¹² Tr. pp. 59-61, 85, 89.

¹¹³ Tr. pp. 69-70; *see also* testimony of W. Parson, Tr. p. 289, 348.

¹¹⁴ Tr. p. 86.

¹¹⁵ Tr. pp. 66-67, 79-80.

¹¹⁶ Tr. pp. 70.

¹¹⁷ Tr. pp. 71.

¹¹⁸ Tr. pp. 390.

¹¹⁹ Tr. pp. A new City payroll system became operational on January 1, 2005.

¹²⁰ Tr. pp. 374-90.

113. Additionally, because of payroll entry errors made in some pay periods from 1995 through December 31, 2004,¹²¹ some or all of the City's insurance supplement payments to some City employees, were taxed as current wages when the payments were made and those payment were therefore not reported as pre-tax benefits.¹²²

114. Between 1995 and 2007, the City changed payroll systems periodically and experienced considerable difficulty when changing from one system to another. That was particularly true of payroll changes made in 1997 and 1998. The current City payroll system became operational on January 1, 2005. At that time, the memory capacity of the computer system that stored the City's payroll records became limited, and the City made the decision to retain only summaries of past total payroll data but not payroll detail. When this occurred, the amounts of City contributions to employee deferred compensation plans became merged with data on other employee pre-tax and after-tax payroll reductions. The City did not retain paper copies of employee paystubs or paychecks.¹²³ As a result, it is now impossible for the City to accurately reconstruct individual employee paystubs and other payroll records prior to 2005.¹²⁴

115. Some of the Petitioners saved their City paystubs for pay periods before January 1, 2005, while others did not. Some of the paystubs that were saved were introduced as evidence. Other Petitioners, particularly those who were not represented by counsel in this proceeding, may have paystubs for pay periods before January 1, 2005, that were not introduced as evidence in this proceeding.¹²⁵

116. It is Mr. Parson's opinion that between 1995 and December 31, 2004, the persons processing the City's biweekly payroll frequently made errors in preparing the payroll documents for City employees, and that those errors resulted in deferred compensation contributions and insurance supplement payments being taxed as current income in pay periods. Because of apparently random patterns of errors and the absence of detailed pay records for that period, it is not possible for the City to reconstruct how much of those nontaxable benefits were improperly subject to federal and state income taxes.¹²⁶

117. Between 1995 and August 1, 2007, because of the random nature of payroll entry errors, the City's payroll system sometimes included the City's deferred compensation and insurance supplement payments in employees' taxable income at the time the payments were made and at other times excluded them from employees' taxable income.¹²⁷

¹²¹ Tr. pp. A new City payroll system became operational on January 1, 2005.

¹²² Tr. pp. 374-90.

¹²³ Ex 111, ¶¶ 16-18.

¹²⁴ *Id.*; Ex. 108, ¶¶ 6, 10; Ex. 112, ¶ 10.

¹²⁵ Ex. 103; Ex. 104; Ex. 105; Ex. 107; Ex. 109; Ex. 110; Ex. 117; Ex. 119.

¹²⁶ Tr. pp. 390-94, 403-04, 406.

¹²⁷ *Id.*; compare Ex. 106, ¶ 4; Ex. 109, ¶ 3; Ex. 112, ¶ 12.

118. Prior to the initiation of these proceedings, the City had never informed PERA that on occasions the City had been including its deferred compensation and family medical coverage payments in its employees' taxable income at the time those payments were made.¹²⁸

119. Therefore, the payroll information that PERA used to recalculate the retirement benefits to City employees and the overpayments for those employees was partly inaccurate.¹²⁹

Consequences of PERA's Recalculation of Benefits

120. The City stopped reporting the City's deferred compensation/family medical coverage payments to PERA as part of salary beginning in August 2007. However, the City did not subsequently inform its employees and retirees that the City's prior payroll practices would likely result in reductions of their PERA retirement benefits.¹³⁰

121. Moreover, during the in-person training sessions that PERA conducted for members between August 1, 2007, and March 9, 2009, PERA did not expressly advise attendees of its interpretation that Minn. Stat. § 353.01, subd. 10, excluded employee-paid deferred compensation payments as salary for PERA reporting purposes.¹³¹

122. In mid-March 2009, PERA advised most City retirees that their benefits had been recalculated and that they were liable for repayment of overpayments. The monthly reductions ranged from approximately \$50 per month to more than \$200 per month. The overpayment amounts ranged from a couple of thousand dollars to approximately \$20,000.¹³²

123. Approximately 485 retired City employees have received letters from PERA and the City of Duluth advising them that their PERA benefits have been reduced and informing them of their liability for overpayments. According to PERA, the total of the erroneously withheld employee contributions was \$1.137 million; the total of the erroneous employer contributions was \$1.414 million, and the net overpayments of excess PERA benefits was \$1.268 million.¹³³

124. Because of the retirement benefit recalculations that PERA made in 2009 and the resulting reductions in retirement benefits and obligations to repay past

¹²⁸ Ex. 14 (at Ex. 8); Ex. 129 (at Ex. E-19).

¹²⁹ See Findings 98 through 110, below.

¹³⁰ Tr. pp. 356-57, 359-60.

¹³¹ Tr. pp. 146-147.

¹³² Ex. 101, at ¶¶ 5-6; Ex. 113, ¶ 8; Ex. 114, ¶ 13; Ex. 115, ¶ 4; Ex. 121, ¶ 3; Ex. 122, ¶ 5; Ex. 123, ¶ 11. Petitioner Bryan Brown, who was the Duluth City Attorney from 2000-2008, was not part of a collective bargaining unit but was also paid deferred compensation which was included in salary for PERA purposes. His retirement benefit was also reduced, but he was notified of the reduction in 2008, several months earlier than the other retirees. See Ex. 130, ¶¶ 7-9.

¹³³ Pet. Mem. in Support of Mot. for Sum. Disp., p. 2; Tr. pp. 358.

apparent overpayments, several City employees have had to rejoin the work force to balance their budgets.¹³⁴

125. PERA has never before contemporaneously reduced the retirement benefits of over 400 employees of a single participating employer.¹³⁵

126. None of the City employees who retired between 1995 and March 9, 2009, were advised by either the City or PERA that City amounts that the City had reported to PERA may have been erroneous, and that PERA might recalculate their annuities to a lesser amount and require repayment of the difference.¹³⁶ Many of the City employees who retired or engaged in pre-retirement planning during that period relied on the retirement information that they received from PERA the City and on the retirement benefit calculations that PERA provided to them.¹³⁷

127. PERA knew or should have known on or after October 8, 2008, that the amounts of PERA eligible salary that the City had reported to PERA for the period from 1995 through August 1, 2007, were likely inaccurate.

128. Some of the Petitioners may have retired between October 8, 2008, and March 9, 2009.¹³⁸ If so, any retirement annuity estimates provided to them by PERA staff were also based on the amounts that the City actually provided to PERA from 1995 up to the date of their retirement. However, even though the City had reported the apparent nature and scope of erroneous PERA payroll information, employees retiring during that period were not advised by either the City or PERA that any annuity estimates provided to them by PERA might be subject to recalculation to a lesser amount.¹³⁹

129. Since at least 1995, whenever PERA has provided benefit estimates to members, it has always explicitly stated that if there is any conflict between the estimate and the law, the law controls. Although PERA relies on participating employers, like the City, to provide accurate information for the calculation of retirement benefits for members contemplating retirement, PERA expressly informs members that the law must control if a conflict or error in benefit calculation occurs.¹⁴⁰

130. Between 1995 and March 9, 2009, PERA did not make representations or inducements to City employees that the estimates of benefits that they had received or would be receiving were firm estimates and not subject to recalculation.¹⁴¹

¹³⁴ Tr. pp. 195-196.

¹³⁵ Tr. pp. 150-51, 171-72.

¹³⁶ Ex. 101.

¹³⁷ Tr. pp 246-49.

¹³⁸ The evidence failed to identify who, if any, retired during that period.

¹³⁹ Ex. 115, ¶ 5; Tr. pp146-47.

¹⁴⁰ Tr. pp. 173-176.

¹⁴¹ *Id.*

Statute of Limitations

131. Before the 2009 Omnibus Pension Bill was enacted, there was no statute of limitations for correcting errors attributable to incorrect eligible wage determinations. PERA therefore had the authority to collect overpayments of the City's employer PERA contributions and City employee PERA deductions and adjust retiree benefits starting with 1995, the first year the City paid deferred compensation benefits.¹⁴²

132. The 2009 Omnibus Pension Bill¹⁴³ provided a new, general statute of limitations for correcting errors attributable to the definition of eligible salary. Under the Bill, the period of adjustment is limited to the fiscal year in which PERA discovers the error, plus the two immediately preceding fiscal years. The provision applies to errors reported on or after May 23, 2009, the enactment date of the legislation.¹⁴⁴

133. The new three-year statute of limitations does not apply to the City's eligible salary errors because these errors were already reported and "in process" prior to enactment of the new legislation. But in the same Act the legislature included special legislation that gave the City the option of electing the new three-year statute of limitations to the extent that adjustments were "in process" as of the date of the enactment. Specifically, the legislature provided :

APPLICATION OF PUBLIC EMPLOYEES RETIREMENT ASSOCIATION ERRONEOUS RECEIPTS AND DISBURSEMENTS PROVISION; ELECTION

(a) If adjustments under Minnesota Statutes, section 353.27, subdivision 7, due to invalid salary amounts are in process as of the effective date of this section for employees or former employees of a governmental subdivision, the governing body of the governmental subdivision may elect to have the statute of limitations under Minnesota Statutes, section 353.27, subdivision 7, paragraphs (c) and (g), apply to adjustments or corrections in process as of the effective date of Minnesota Statutes, section 353.27, subdivision 7, by a resolution of the governing body transmitted to the Public Employees Retirement Association executive director within 90 days after the effective date of this section.

(b) If the governing body of the governmental subdivision declines the treatment permitted under paragraph (a) or fails to submit a resolution in a timely manner, the statute of limitations does not apply to adjustments or corrections in process as of the effective date.¹⁴⁵

134. In the 2009 Omnibus Pension Bill, the legislature also provided special procedures by which PERA and the City could correct employee deductions and employer contributions attributable to errors in determining eligible salary reported between January 1, 1997, and October 23, 2008, and to adjust related retiree benefits.

¹⁴² Ex. 14 at Ex. 14.

¹⁴³ Act of May 22, 2009, ch. 169, art. 4, secs. 11, 49-50. 2009 Minn. Laws 2328-2329.

¹⁴⁴ Ex. 14, *citing* ch. 169, art. 4, sec. 11, subds. 7(c) and 7(g).

¹⁴⁵ Ch. 169, S.F. 191, Art. 4, § 50.

Under the special legislation, the City could opt to use those special procedures to override other sections of Minnesota statutes providing for a modified statute of limitations and different procedures for correcting prior errors in defining eligible salary.¹⁴⁶

135. Under the three-year statute of limitations, the City's retirees would not have had to pay fifteen years worth of overpayments. Rather, the new limitation would only have allowed PERA to recover only three years worth of erroneous deductions from active members and retirees.¹⁴⁷

136. The City did not pass a resolution to elect the application of a three-year statute of limitations in the instant matter.

Other Findings

137. These Findings are based on all of the evidence in the record. Citations to portions of the record are not intended to be exclusive references.

138. To the extent that the Memorandum that follows explains the reasons for these Findings of Fact and contains additional findings of fact, including findings on credibility, the Administrative Law Judge incorporates them into these Findings.

139. The Administrative Law Judge adopts as Findings any Conclusions that are more appropriately described as Findings.

Based on the above Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. The Administrative Law Judge and the PERA Board of Trustees have jurisdiction of this proceeding pursuant to Minn. Stat. §§ 14.57 – 14.62 and Minn. Stat. § 356.96, subd. 12(b).

2. The Notices of Hearing in this matter were proper, and all relevant substantive and procedural requirements of law or rule have been fulfilled. This matter is properly before the Administrative Law Judge and the PERA Board of Trustees.

3. The unused personal leave days of active City firefighters are "salary" within the meaning of Minn. Stat. § 353.01, subd. 10, and that that determination is retroactive and is applicable to all City firefighters currently employed or retired.¹⁴⁸

4. Before enactment of the 2009 Omnibus Pension Bill,¹⁴⁹ there was no statute of limitations for correcting errors attributable to incorrect eligible wage

¹⁴⁶ Ch. 169, S.F. 191, Art. 4, § 49; see also Ex. 14 at Ex. 14.

¹⁴⁷ See Trans. at pp. 182-183.

¹⁴⁸ Finding 10.

¹⁴⁹ Act of May 22, 2009, ch. 169, art. 4, secs. 11, 49-50. 2009 Minn. Laws 2328-2329.

determinations, and there was therefore no limit on PERA's ability to collect overpayments of employee deductions and employer contributions and adjust retiree benefits based on past errors by participating employers in reporting PERA eligible salaries.

5. Among others, 2009 Minn. Laws, ch. 169, art. 4, sec. 11, enacted the following amendments to Minn. Stat. § 353.27, subd. 7:

c) Adjustments to correct employer contributions and employee deductions taken in error from amounts which are not salary under section 353.01, subdivision 10, must be made as specified in paragraph (e). The period of adjustment must be limited to the fiscal year in which the error is discovered by the association and the immediate two preceding fiscal years.

* * *

(g) If the accrual date of any retirement annuity, survivor benefit, or disability benefit is within the limitation period specified in paragraph (c), and an overpayment has resulted by using invalid service or salary, or due to any erroneous calculation procedure, the association must recalculate the annuity or benefit payable and recover any overpayment as provided under subdivision 7b.

2009 Minn. Laws, ch. 169, made Minn. Stat. § 353.27, subd. 7, as amended, effective on the date following enactment, which was May 23, 2009. Because PERA had already made corrections of the apparent erroneous PERA salary information reported by the City on or about March 9, 2009, the new statute of limitations did not apply to those corrections.

6. However, 2009 Minn. Laws, ch. 169, art. 4, secs. 49-50 also enacted the following two special laws, were applicable to the City of Duluth and which enabled the City and its employee to take advantage of the statute of limitations enacted in Minn. Stat. § 353.27, subd. 7(c) and (g):

**Sec. 49. CITY OF DULUTH AND DULUTH AIRPORT AUTHORITY;
CORRECTING ERRONEOUS EMPLOYEE DEDUCTIONS, EMPLOYER
CONTRIBUTIONS AND ADJUSTING OVERPAID BENEFITS.**

Subdivision 1. Application. Notwithstanding any provisions of Minnesota Statutes, section 353.27, subdivisions 7 and 7b, or Minnesota Statutes 2008, chapters 353 and 356, to the contrary, this section establishes the procedures by which the executive director of the Public Employees Retirement Association shall adjust erroneous employee deductions and employer contributions paid on behalf of active employees and former members by the city of Duluth and by the Duluth Airport Authority on amounts determined by the executive director to be invalid salary under Minnesota Statutes, section 353.01, subdivision 10, reported between January 1, 1997, and October 23, 2008, and for adjusting benefits that

were paid to former members and their beneficiaries based upon invalid salary amounts.

Subd. 2. Refunds of employee deductions. (a) The executive director shall refund to active employees or former members who are not receiving retirement annuities or benefits all erroneous employee deductions identified by the city of Duluth or by the Duluth Airport Authority as deductions taken from amounts determined to be invalid salary. The refunds must include interest at the rate specified in Minnesota Statutes, section 353.34, subdivision 2, from the date each invalid employee deduction was received through the date each refund is paid.

(b) The refund payment for active employees must be sent to the applicable governmental subdivision which must pay the refunded employee deductions plus interest to the active members who are employees of the city of Duluth or who are employees of the Duluth Airport Authority, as applicable.

(c) Refunds to former members must be mailed by the executive director of the Public Employees Retirement Association to the former member's last known address.

Subd. 3. Benefit adjustments. (a) For a former member who is receiving a retirement annuity or disability benefit, or for a person receiving an optional annuity or survivor benefit, the executive director must:

(1) adjust the annuity or benefit payment to the correct monthly benefit amount payable by reducing the average salary under Minnesota Statutes, section 353.01, subdivision 17a, by the invalid salary amounts;

(2) determine the amount of the overpaid benefits paid from the effective date of the annuity or benefit payment to the first of the month in which the monthly benefit amount is corrected;

(3) calculate the amount of employee deductions taken in error on invalid salary, including interest at the rate specified in Minnesota Statutes, section 353.34, subdivision 2, from the date each invalid employee deduction was received through the date the annuity or benefit is adjusted as provided under clause (1); and

(4) determine the net amount of overpaid benefits by reducing the amount of the overpaid annuity or benefit as determined in clause (2) by the amount of the erroneous employee deductions with interest determined in clause (3). (b) If a former member's erroneous employee deductions plus interest determined under this section exceeds the amount of the person's overpaid benefits, the balance must be refunded to the person to whom the annuity or benefit is being paid.

(c) The executive director shall recover the net amount of all overpaid annuities or benefits as provided under subdivision 4.

Subd. 4. Employer credits and obligations. (a) The executive director shall provide a credit without interest to the city of Duluth and to the Duluth Airport Authority for the amount of that governmental subdivision's erroneous employer contributions. The credit must first be used to offset the net amount of the overpaid retirement annuities and the disability and survivor benefits that remains after applying the amount of erroneous employee deductions with interest as provided under subdivision 3, paragraph (a), clause (4). The remaining erroneous employer contributions, if any, must be credited against future employer contributions required to be paid by the applicable governmental subdivision. If the overpaid benefits exceed the employer contribution credit, the balance of the overpaid benefits is the obligation of the city of Duluth or the Duluth Airport Authority, whichever is applicable.

(b) The Public Employees Retirement Association board of trustees shall determine the period of time and manner for the collection of overpaid retirement annuities and benefits, if any, from the city of Duluth and the Duluth Airport Authority.

EFFECTIVE DATE.(a) This section is effective for the city of Duluth the day after the Duluth city council and the chief clerical officer of the city of Duluth timely complete their compliance with Minnesota Statutes, section 645.021, subdivisions 2 and 3, for members who are, and former members who were, employees of the city of Duluth.

(b) This section is effective for the Duluth Airport Authority the day after the Duluth Airport Authority and the chief clerical officer of the Duluth Airport Authority timely complete their compliance with Minnesota Statutes, section 645.021, subdivisions 2 and 3, for members who are, and former members who were, employees of the Duluth Airport Authority.

Sec. 50. APPLICATION OF PUBLIC EMPLOYEES RETIREMENT ASSOCIATION ERRONEOUS RECEIPTS AND DISBURSEMENTS PROVISION; ELECTION.

(a) If adjustments under Minnesota Statutes, section 353.27, subdivision 7, due to invalid salary amounts are in process as of the effective date of this section for employees or former employees of a governmental subdivision, the governing body of the governmental subdivision may elect to have the statute of limitations under Minnesota Statutes, section 353.27, subdivision 7, paragraphs (c) and (g), apply to adjustments or corrections in process as of the effective date of Minnesota Statutes, section 353.27, subdivision 7, by a resolution of the governing body transmitted to the Public Employees Retirement Association executive director within 90 days after the effective date of this section.

(b) If the governing body of the governmental subdivision declines the treatment permitted under paragraph (a) or fails to submit a resolution in a timely manner, the statute of limitations does not apply to adjustments or corrections in process as of the effective date.

EFFECTIVE DATE. This section is effective the day after final enactment.

7. However, the City failed to elect to have the statute of limitations under Minnesota Statutes, section 353.27, subdivision 7, paragraphs (c) and (g), apply to adjustments or corrections in process as of the effective date of Minn. Stat. § 353.27, subd. 7 by passing a resolution of the City's governing body within 90 days after the effective date of 2009 Minn. Laws, ch. 169, art. 4, sec. 50. The statute of limitations contained in Minn. Stat. § 353.27, subd. 7(c) and (g), therefore does not apply to PERA's recalculations of the salaries of City employees based on any erroneous reports by the City for pay periods between January 1, 1997, and October 23, 2008.¹⁵⁰

8. The Petitioners have the burden to establish by a preponderance of the evidence that PERA is barred from recalculating their retirement benefits by the doctrines of promissory or equitable estoppel.¹⁵¹

9. The Petitioners failed to establish by a preponderance of the evidence that PERA is barred from recalculating their retirement benefits by the doctrines of promissory or equitable estoppel.¹⁵²

10. An agency policy that makes specific a statute enforced or administered by the agency is an interpretive rule that must be promulgated in accordance with Minnesota Statutes, Chapter 14, unless the policy simply corresponds with the plain meaning of the statute at issue. However, if an agency policy purports to interpret ambiguous governing legislation, the agency need not engage in formal rulemaking if its interpretation is long standing.¹⁵³

11. The City's contributions to family-dependent hospital-medical premiums are "employer-paid amounts used by an employee toward the cost of insurance coverage" within the meaning of Minn. Stat. § 353.01, subd. 10(b) (2). PERA's policy of excluding the City's contributions to family-dependent hospital-medical premiums from PERA salary corresponds with the plain meaning of Minn. Stat. § 353.01, subd. 10(b) (2), and is therefore not an interpretive rule.¹⁵⁴

12. Minn. Stat. § 353.01, subd. 10, is ambiguous about whether employer contributions to deferred compensation plans are excluded from PERA salary. Interpreting Minn. Stat. § 353.01, subd. 10, to exclude employer-paid deferred compensation is a correct resolution of that ambiguity. However, PERA's application of that interpretation represents enforcement of an interpretive rule, and that interpretation

¹⁵⁰ See also Part II of the Memorandum that follows.

¹⁵¹ See Part I of the Memorandum that follows.

¹⁵² See Part III of the Memorandum that follows.

¹⁵³ *Mapleton Community Home, Inc. v. Minnesota Department of Human Services*, 391 N.W.2d 798, 801 (Minn. 1986) (*Mapleton Community Home*), citing *Cable Communications Board v. Nor-West Cable Communications Partnership*, 356 N.W.2d 658, 667 (Minn.1984) (*Cable Communications*). See Part IV-A of the Memorandum that follows.

¹⁵⁴ See Part IV-B of the Memorandum that follows.

does not qualify as long standing. PERA may therefore not enforce that interpretation when recalculating the retirement benefits of City employees.¹⁵⁵

13. Whenever the City included its deferred compensation payments in employees' taxable income, those payments lost their character as fringe benefits and became current wages.¹⁵⁶

14. The City's insurance supplement payments were PERA salary even when they were subject to income taxes when made.¹⁵⁷

15. PERA bears the burden in this proceeding of establishing by a preponderance of the evidence that the recalculations of the Petitioners' retirement benefits that PERA is proposing were accurate, and not erroneous, recalculations.¹⁵⁸

16. A preponderance of the evidence in this proceeding established that the information that the City supplied about past deferred compensation payments was demonstrably inaccurate because it included deferred compensation payments on which employees paid income taxes at the time the payments were made.¹⁵⁹

17. Minn. Stat. § 353.27, subd. 11(b) provides:

(b) In the event payroll abstract records have been lost or destroyed, for whatever reason or in whatever manner, so that such schedules of salaries cannot be furnished therefrom, the employing governmental subdivision, in lieu thereof, shall furnish to the association an estimate of the earnings of any employee or former employee for any period as may be requested by the executive director. If the association is provided a schedule of estimated earnings, the executive director is authorized to use the same as a basis for making whatever computations might be necessary for determining obligations of the employee and employer to the general employees retirement plan, the public employees police and fire retirement plan, or the local government correctional employees retirement plan. If estimates are not furnished by the employer at the request of the executive director, the executive director may estimate the obligations of the employee and employer to the general employees retirement fund, the public employees police and fire retirement plan, or the local government correctional employees retirement plan based upon those records that are in its possession.

18. Because information that the City previously supplied to PERA about past deferred compensation payments was demonstrably inaccurate, PERA's recalculations

¹⁵⁵ See Parts IV-C, IV-D, and IV-E of the Memorandum that follows.

¹⁵⁶ See Part V-A of the Memorandum that follows.

¹⁵⁷ See Part V-B of the Memorandum that follows.

¹⁵⁸ See Part I, *supra*.

¹⁵⁹ See Part VI of the Memorandum that follows.

of the obligations of the City and its employees to the general employees retirement fund are also inaccurate.

19. Any Finding of Fact more properly termed a Conclusion is adopted as such. Any Conclusion more properly termed a Finding of Fact is adopted as such.

20. These Conclusions are reached for the reasons discussed in the Memorandum that follows, which is hereby incorporated into these Conclusions.

Based upon the above Conclusions, the Administrative Law Judge makes the following:

RECOMMENDATIONS

The Administrative Law Judge respectfully recommends that the PERA Board of Trustees:

(1) As a consequence of PERA's improper enforcement of an unadopted interpretive rule, REVISE the most recent recalculations of City contributions and City employees' contributions, overpayments, and retirement benefits to include as PERA salary employer deferred compensation payments made from 1995 to the; or

(2) Alternatively, MODIFY the recalculations of PERA retirement benefits of all other City employees to include as PERA salary City deferred compensation contributions that were included in employees' taxable income at the time those contributions were made; and

(3) Require the City to provide PERA with more accurate estimates of its employees' PERA-eligible salary for the period from 1995 to the present.

Dated: January 18, 2011

s/Bruce H. Johnson

BRUCE H. JOHNSON
Administrative Law Judge

Reported: Kirby A. Kennedy and Associates
Transcripts Prepared (Two Volumes)

NOTICE

This Report is a recommendation, not a final decision. The PERA Board of Trustees will make the final decision after a review of the record. The Board may adopt, reject or modify the Findings of Fact, Conclusions, and Recommendations contained herein. Pursuant to Minn. Stat. § 14.61, the final decision of the Board shall not be made until this Report has been made available to the parties to

the proceeding for at least five days. An opportunity must be afforded to each party adversely affected by this Report to file exceptions and present argument to the Board. Parties should contact Mary Vanek, Executive Director, Public Employees Retirement Association, 50 Empire Drive, Suite 200, St. Paul, Minnesota 55103-2088, to ascertain the procedure for filing exceptions or presenting argument.

If the Board fails to issue a final decision within 90 days of the close of the record, this report will constitute the final agency decision under Minn. Stat. § 14.62, subd. 2a. The record closes upon the filing of exceptions to the report and the presentation of argument to the Board, or upon the expiration of the deadline for doing so. The Board must notify the parties and the Administrative Law Judge of the date on which the record closes.

MEMORANDUM

I. The parties share the burden of proof.

In March 12, 2009, the PERA staff sent written notices to approximately 485 current and former City employees informing them that the City had erroneously reported certain amounts that the City had paid to them between 1997 and 2008 as being “salary” for purposes of calculating retirement contributions and benefits.¹⁶⁰ Those notices informed the employees that if they disagreed with PERA’s salary and benefit calculations, they could file petitions for review by filling out and submitting an enclosed form. Subsequently, 70 of the current and retired City employees who received those letter notifications filed the attached petitions for review.¹⁶¹ Thereafter, the PERA Board of Trustees initiated contested case proceedings by issuing 70 notices of hearing and filing them with OAH. Five of the six issues raised by the PERA Board in the Notices of Hearing were primarily issues of law. The sixth issue—whether it was reasonable for PERA Staff to rely on salary information supplied by the City was primarily an issue of fact.

In arguing that the Petitioners have the burden of proof with respect to all disputed issues, the PERA staff relies on Minn. R. 1400.7300, subp. 5, which provides that “[t]he party proposing that certain action be taken must prove the facts at issue by a preponderance of the evidence, unless the substantive law provides a different burden or standard.” The ALJ agrees, in part, with the PERA Staff’s position on burden of proof but also disagrees, in part.

First, although the Petitioners are identified as opposing parties by the Notices of Hearing, the PERA Board’s statement of the issues to be addressed by the ALJ are more in the nature of a request for advisory opinions. In other words, although the Notices of Hearing do not frame the issue as such, the outcome that both PERA and the Petitioners wish to have settled is whether or not PERA’s recalculation of the Petitioner’s retirement benefits was correct. It is ultimately the correctness of that recalculation that the PERA Staff proposes to have confirmed. However, a state

¹⁶⁰ Finding 1.

¹⁶¹ Finding 2.

agency cannot avoid its responsibility as the proponent of substantive agency action by the way it chooses to characterize the issues in notice of hearing in a contested case. The fact that PERA chose to seek confirmation of its recalculations by inviting the Petitioners to challenge them on a standardized form and chose to do so does not make the Petitioners proponents of anything substantively at issue.¹⁶²

As to the ultimate issue—whether PERA has correctly recalculated the Petitioners’ retirement benefits—the Petitioners do not have the obligation, or in most cases the means, to correctly recalculate their own retirement benefits. The City has a statutory duty under Minn. Stat. § 353.28, subd. 1, to provide PERA with accurate information about the amounts of compensation paid to its employees that qualify as PERA salary, and PERA has the authority to enforce that obligation. PERA alone has the actuarial expertise to recalculate benefits using correct information. Thus, at least with regard to the ultimate issue here, a more realistic approach to allocating the burden of proof is to impose the burden on the Petitioners to establish by a preponderance of the evidence that the information or estimates on which PERA relied when recalculating their retirement benefits was demonstrably incorrect. If they are able to meet that burden, the burden then shifts to PERA to again recalculate the Petitioners’ retirement benefits using more correct information or estimates.

Further, Minn. R. 1400.7300, subp. 5, also provides that “[a] party asserting an affirmative defense shall have the burden of proving the existence of the defense by a preponderance of the evidence.” Here, the Petitioners are not uniquely disabled from meeting that burden in connection with their promissory and equitable estoppel defenses. Therefore, even though the PERA Board raised those issues in the first instance in the Notice of Hearing, those are generally held to be affirmative defenses. It is therefore not unreasonable to require the Petitioners bear the burden of proof and persuasion with respect to their defenses to recalculation.

Finally, during the hearing, PERA asserted and presented evidence that its interpretation that Minn. Stat. § 353.01, subd. 10(b)(2) excludes the City’s insurance supplement and deferred compensation from treatment as PERA salary constitutes a longstanding agency interpretation that is entitled to deference.¹⁶³ By letter dated October 21, 2010, the ALJ also invited the parties to address the related issue of whether PERA’s interpretation of that statute should be treated as an “interpretive rule” that has not been properly adopted in accordance with Chapter 14 of Minnesota Statutes. It is therefore reasonable to impose on PERA the burden of establishing that its interpretation of the statute is a longstanding agency interpretation, which would except PERA from having to formally adopt it as an interpretive rule.

¹⁶² See MINNESOTA ADMINISTRATIVE PROCEDURE § 10.3.1 (George A. Beck et al. eds. 2d ed. 1998).

¹⁶³ Tr. pp. 121-26; see also PERA’s Post-Hearing Memorandum dated November 23, 2010 (PERA Post-Hrg. Mem.) at pp. 13-14.

II. PERA is not barred from recalculating the retirement benefits of City employees by any statute of limitations.

The time frame in which PERA can correct erroneous contributions and recover overpaid benefits is set forth in Minn. Stat. § 353.27, subd. 7(b). Before 1990, that section contained a three-year statute of limitations but in that year was amended to allow erroneous deductions to be refunded “at any time.”¹⁶⁴ In 1991, Minn. Stat. § 353.27, subd. 7(b) was further amended to require the suspension of benefits “until all outstanding money has been recovered.”¹⁶⁵ Finally, in 2009, the legislature reversed course and again amended the law to place a three-year limitation on the correction of erroneous contributions and deductions and resulting overpayments.¹⁶⁶ Although the legislature also enacted special legislation giving the City the opportunity to opt into the three-year statute of limitations, the City did not do so.

The City informed PERA of the error in its financial reporting in 2008, and the errors occurred from 1996 to 2007. From 1996-2007, Minn. Stat. § 353.27 allowed erroneous deductions to be refunded “at any time,” and it allowed the suspension of benefits “until all outstanding money has been recovered.” No other statute of limitations applies.¹⁶⁷

III. PERA is not barred from recalculating the retirement benefits of City employees by the doctrines of promissory and equitable estoppel.

A. As a matter of law, PERA cannot be estopped from collecting overpayments from and reducing the retirement benefits of City employees.

Minnesota’s appellate courts have long held that estoppel cannot be applied against a government agency when doing so would cause the agency to act outside the bounds of its authority.¹⁶⁸ Although the Minnesota Supreme Court has in the past created some limited exceptions, it has subsequently reaffirmed the general rule that estoppel does not lie against a government entity. In *State v. Horr*,¹⁶⁹ the court adopted a broad rule that equitable estoppel was not available against the government “when it acted in its prerogative of sovereignty,” but that estoppel could be applied against the

¹⁶⁴ Minn. Laws 1990, ch. 570, art. 11, sec. 5; see also *In the Matter of the Retirement Benefits of Robert W. Larson*, C7-95-2512, 1996 WL 310344 (Minn. App.).

¹⁶⁵ Act of June 5, 1991, ch. 341, sec. 11; 1991 Minn. Laws 2534.

¹⁶⁶ Act of May 22, 2009, ch. 169, art. 4, sec. 11; 2009 Minn. Laws 2328-2329.

¹⁶⁷ See *Lucas v. American Family Ins. Co.*, 403 N.W.2d 646, 650 (Minn. 1987) (time limitations of Minn. Stat. § 541.05 apply only to judicial proceedings); *Nicholson v. Ind. Sch. Dist. 636*, 1992 WL 48112 (Minn. App. 1992) (holding that where the applicable law does not contain a time limitation on administrative action, the courts have not provided one).

¹⁶⁸ *In the Matter of the Application for PERA Retirement Benefits of Michael A. McGuire*, 756 N.W. 2d 517, 519 (Minn. App. 2008), citing *Bd. of Educ. of Minneapolis v. Sand*, 34 N.W.2d 689, 695 (1948) (declining to estop school board from denying tenure because governing statute did not authorize granting tenure).

¹⁶⁹ 205 N.W. 444 (Minn. 1925).

government when it acted in a proprietary capacity.¹⁷⁰ However, the court later rejected that distinction in *Mesaba Aviation Div. of Halvorson of Duluth, Inc. v. County of Itasca*.¹⁷¹ There, the court explicitly retained the “authorized-act” limitation on estoppel against government entities.¹⁷²

Three post-*Mesaba* appellate decisions have further confirmed the efficacy of the “authorized-act” limitation on in contexts similar to this case. In *Axelson v. Minneapolis Teachers’ Retirement Fund Association*,¹⁷³ a teacher in the Minneapolis school district, was told in 1974 that he could purchase retirement service credits for a leave of absence that he took in 1966, that he need not make the purchase until a future date, but that the payment amount would accrue interest until paid. Axelson attempted to purchase the service credits in 1990, but the MTRFA refused and informed him that its laws did not allow him to make payment and obtain teaching service credit for his leave of absence.¹⁷⁴ The Court of Appeals found that the MTRFA was estopped from denying him the right to purchase the retirement service credits.¹⁷⁵ The Minnesota Supreme Court reversed, concluding that the MTRFA lacked authority to approve Axelson’s request to purchase the service credits or to retroactively apply an amendment to the association’s articles of incorporation that permitted purchase of retirement service credits. The court therefore held that the doctrine of promissory estoppel could not be invoked,¹⁷⁶ emphasizing that “where an agency has no authority to act, agency action cannot be made effective by estoppel.”¹⁷⁷

Relying on *Axelson*, the Minnesota Court of Appeals in *McGuire*¹⁷⁸ held that PERA could not be estopped from rescinding unauthorized annuity benefits. McGuire resigned from his position as City Administrator of Bayport effective April 2005. PERA determined that McGuire was eligible for unreduced early-retirement benefits and began paying him retirement benefits on May 1, 2005. In July 2007, PERA notified McGuire that it was ceasing retirement payments effective September 1, 2007, and that it would recover all payments paid in the amount of \$112,969.20, because McGuire had violated a statutory requirement that he completely and continuously separate for 30 days from employment as a public employee. McGuire petitioned the PERA Board of Trustees for review, arguing that he was never told about the 30-day requirement even though he attended a PERA-sponsored pre-retirement session and met twice with PERA staff. The PERA Board denied his petition and McGuire appealed to the court of appeals, arguing that PERA had abused its discretion by rescinding his payments without addressing his equitable estoppel claim. The court of appeals ruled in favor of PERA. Because McGuire had admitted that he had failed to meet the statutory requirements for receiving benefit payments, the court reasoned that the payments he received were

¹⁷⁰ *Id.* at 445.

¹⁷¹ 258 N.W.2d 877, 880 (Minn. 1977).

¹⁷² See, *McGuire*, 756 N.W.2d at 520, citing *Mesaba*, 258 N.W.2d at 879.

¹⁷³ *Axelson v. Minneapolis Teachers’ Retirement Fund Ass’n*, 532 N.W.2d 594 (Minn. App. 1995).

¹⁷⁴ See, *Axelson*, 544 N.W.2d at 298-299.

¹⁷⁵ *Axelson v. Minneapolis Teachers’ Retirement Fund Ass’n*, 532 N.W.2d 594, 597-98 (Minn. App. 1995).

¹⁷⁶ 544 N.W.2d at 302.

¹⁷⁷ 544 N.W.2d 297, 299-300 (1996).

¹⁷⁸ 756 N.W. 2d 517.

unauthorized, and that estoppel could not be applied to require the agency to make unauthorized payments. Rescission of the erroneous payments was therefore unavailable as a remedy.¹⁷⁹

In the *Matter of the Appeal of Roger Ogren to the Board of Trustees of the State of Minnesota Teachers Retirement Association*,¹⁸⁰ Ogren challenged the decision of the TRA, arguing that the doctrines of promissory and equitable estoppel precluded alteration of his retirement benefit from the amount calculated in his pre-retirement estimate statement.¹⁸¹ The Court of Appeals reasoned that the threshold issue was whether the retirement association had the authority to pay Ogren the benefit amount calculated in the pre-retirement benefit estimates. The court found that the retirement association had to calculate Ogren's "high-five average salary" using the statutory definition of "salary," but the salaries used to produce his pre-retirement estimates included payments that were excluded from the statutory definition. The court concluded that the estimates were calculated improperly and could not be used to determine Ogren's monthly annuity. The court wrote: "The retirement association does not have the authority to calculate Ogren's 'high-five average salary' by using a different definition of 'salary' from that provided in Minn. Stat. § 354.05, subd. 35, so neither promissory nor equitable estoppel can be employed to vouchsafe the pre-retirement estimate provided by the association calculating Ogren's retirement benefit."¹⁸²

In summary, regardless of the equities involved, the law continues to be that a government agency's unauthorized act cannot be made effective by estoppel.¹⁸³ Here, the legislature has mandated how PERA must calculate members' retirement benefits and has prescribed the procedure by which PERA must collect overpayments and correct erroneous contributions and deductions. The PERA Board has no authority to deviate from the statutory procedures when correcting erroneous deductions and contributions and overpayments to members as set forth in Minn. Stat. § 353.27, subd. 7, subd. 7a and subd. 7b.

B. Even if estoppel were available, essential elements of estoppel are absent here.

There are occasions when the doctrine of estoppel can be applied against a governmental agency. When that occurs, a party seeking to invoke equitable estoppel against a government agency bears a "heavy burden of proof."¹⁸⁴ The party asserting estoppel against a government agency must prove five elements: 1) that representations or inducements were made to the claimants; 2) that there has been reasonable reliance on those representations or inducements by the claimants; 3) that the representations or inducements involve some element of fault or wrongful conduct by the government agency; 4) that the claimant will be harmed if estoppel is not

¹⁷⁹ 756 N.W.2d at 520.

¹⁸⁰ 1997 WL 118254, CO-96-1390, (Minn. App.).

¹⁸¹ 1997 WL 118254.

¹⁸² 1997 WL 118254, *3.

¹⁸³ See, *McGuire*, 756 N.W.2d at 520.

¹⁸⁴ *Brown v. Minnesota Dept. of Pub. Welfare*, 368 N.W.2d 906, 910 (Minn. 1985).

allowed; and 5) the equities of the case outweigh any public interest frustrated by the estoppel.¹⁸⁵

Here, while Petitioners' situation evokes sympathy, a preponderance of the evidence fails to establish at least two of the essential elements. It was Patricia Kapplehoff unchallenged testimony that whenever PERA provides benefit estimates to members, it always explicitly states that if there is any conflict between the estimate and the law, the law controls.¹⁸⁶ Although PERA relies on participating employers, like the City, to provide accurate information for the calculation of retirement benefits for members contemplating retirement, PERA expressly informs them that the law must control if a conflict or error in benefit calculation occurs. There was no evidence that PERA has ever made representations or inducements to City employees that the estimates of benefits that they received were certain and not subject to recalculation. Concomitantly, reliance on PERA's benefit estimates and calculations was not reasonable.

Finally, the third essential element of estoppel appears to be missing here—namely, that the representations or inducements made involve an element of fault or wrongful conduct by the government agency against which estoppel is being sought. Here, the City had a statutory obligation to provide PERA with accurate salary information, and it was the City, not PERA, that provided PERA with erroneous salary information. Because PERA currently lacks both the authority and resources to audit and verify the salary information provided by participating employers, it cannot be said that PERA was at fault by relying on the information submitted by the City.

IV. PERA's Interpretation of Minn. Stat. § 353.01, subd. 10(b)(2), as It Pertains to Employer-Paid Deferred Compensation, is Unenforceable as an Unadopted Interpretive Rule

PERA argues that its interpretations that Minn. Stat. § 353.01, subd. 10(b)(2) must be given deference as a long-standing agency interpretation. However, for the reasons discussed below, the ALJ concludes that PERA's interpretation of the statute, as it pertains to employer-paid deferred compensation, is not entitled to such deference. Rather, that interpretation represents an unenforceable, unadopted interpretive rule.

A. Agency interpretations of legislation that they administer are normally considered to be interpretive rules that must normally be formally adopted to be enforceable.

PERA argues that PERA's interpretations of Minn. Stat. § 353.01, subd. 10, must be given deference. Minnesota's appellate courts have long held that an agency's interpretation of its governing legislation is entitled to deference in some cases.¹⁸⁷ But that principle of deference may on occasions conflict with the statutory agency

¹⁸⁵ *Brown*, 368 N.W.2d at 910.

¹⁸⁶ Tr. pp. 173-176 (Finding 129).

¹⁸⁷ *In re Abbott's Estate*, 6 N.W.2d 466, 467 (Minn. 1942).

rulemaking requirements set forth in Minn. Stat. Chapter 14. Minn. Stat. § 14.02, subd. 4, defines “rule” as:

every agency statement of general applicability and future effect, including amendments, suspensions, and repeals of rules, adopted to implement or make specific the law enforced or administered by that agency or to govern its organization or procedure.

Thus, the Minnesota Supreme Court has held that:

An agency interpretation that “make[s] specific the law enforced or administered by the agency” is an interpretive rule that is valid only if promulgated in accordance with the Act.¹⁸⁸

However, there are two exceptions to that requirement of formal rule promulgation. The first is:

Not all interpretations, however, constitute interpretive rules. If an agency's interpretation corresponds with the plain meaning of the rule it construes, the agency is not deemed to have promulgated a new rule.¹⁸⁹

Second, if a statute or rule is ambiguous

and the agency interpretation is a longstanding one, the agency is not deemed to have promulgated a new rule.¹⁹⁰

PERA's interpretations of Minn. Stat. § 353.01, subd. 10(b)(2), were clearly intended to make specific a law that PERA administers. Although Minn. Stat. § 353.18 requires that “[a]ll matters and administrative details not specifically provided for in this chapter shall be governed by rules issued and promulgated by the board of trustees,” the PERA Board has never formally promulgated PERA's interpretations of Minn. Stat. § 353.01, subd. 10(b)(2) as an agency rule. Nevertheless, if PERA's interpretations simply correspond with the statute's plain meaning, those interpretations are not considered to be interpretive rules requiring formal promulgation. However, if the statute is ambiguous, PERA's interpretations must qualify as long standing interpretations to avoid the requirement of formal promulgation. Thus, issues that must be addressed are: Is Minn. Stat. § 353.01, subd. 10, ambiguous about whether the City's contributions to family-dependent hospital-medical premiums and employer-paid deferred compensation must be excluded from PERA salary? If the subdivision is ambiguous about treatment of either payment, do PERA's interpretations then qualify as long standing ones?

¹⁸⁸ *Mapleton Community Home, Inc. v. Minnesota Department of Human Services*, 391 N.W.2d 798, 801 (Minn. 1986) (*Mapleton Community Home*).

¹⁸⁹ *Id.*, citing *Cable Communications Board v. Nor-West Cable Communications Partnership*, 356 N.W.2d 658, 667 (Minn.1984) (*Cable Communications*).

¹⁹⁰ *Id.*

B. PERA’s interpretation that Minn. Stat. § 353.01, subd. 10(b)(2), excludes the City’s contributions to family-dependent hospital-medical premiums from PERA salary corresponds with the statute’s plan meaning and is not an interpretive rule.

Petitioner Bryan Brown argued that the way in which the City managed the hospital and medical costs of its employees did not constitute “insurance.” The ALJ disagrees, at least with respect to family and dependent hospital and medical costs, which are the only hospital and medical costs at issue here. The evidence established that employees had to bear the full cost of family coverage, by paying an annual family *coverage premium* set by the City and its third-party coverage administrator.¹⁹¹ Insurance is “an agreement by which one party assumes a risk faced by another party in return for a premium payment.”¹⁹² Although the City’s arrangement may have represented self-insurance, it was “insurance” within the meaning of that term. Minn. Stat. § 353.01, subd. 10 (b), expressly excludes “[e]mployer-paid amounts used by an employee toward the cost of insurance coverage.” PERA’s interpretation that the City’s contributions to family-dependent hospital-medical premiums is excluded from PERA salary simply reflects the plain meaning of the statute. It is therefore not an interpretive rule.¹⁹³

C. However, Minn. Stat. § 353.01, subd. 10, is ambiguous about whether employer contributions to deferred compensation plans from PERA salary are excluded from PERA.

PERA’s governing legislation has defined the term “salary” for PERA’s purposes since 1933.¹⁹⁴ The legislature did not begin expressly excluding certain kinds of employer payments to public employees from treatment as PERA salary until four decades later in 1974. In 1973 the legislature amended Minn. Stat. § 353.01, subd. 10(a), to include “deductions for deferred compensation.” In other words, there still was nothing in the 1973 version of the statute that explicitly or implicitly excluded employer deferred compensation payments. In 1974, the legislature amplified the definition of salary in Minn. Stat. § 353.01, subd. 10(a), by amending it to read “before deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs.”¹⁹⁵ Again, it would have been reasonable to infer in 1974 that “deductions for deferred compensation” included both employee and employer deferred compensation contributions because there was nothing in the statute even arguably excluding the latter.

Seventeen years later in 1991, the legislature began adding language to Minn. Stat. § 353.01, subd. 10, that described amounts that were to be excluded from PERA salary. Some exclusions were listed in paragraph (a); another was listed in a new paragraph (b). But none of exclusions explicitly or implicitly excluded employer-

¹⁹¹ Finding 71; see also Ex. 108, ¶ 9; Ex. 111, ¶ 12; Ex. 130, ¶¶ 2-4.

¹⁹² BLACK’S LAW DICTIONARY 802 (7th ed. 1999).

¹⁹³ *Mapleton Community Home, supra*, 391 N.W.2d at 801.

¹⁹⁴ Findings 28 through 31.

¹⁹⁵ Finding 32.

paid deferred compensation, and it would still be reasonable to infer that Minn. Stat. § 353.01, subd. 10(a) still covered both employee and employer deferred compensation contributions. In 1993, the legislature amended and reorganized Minn. Stat. § 353.01, subd. 10(a) and (b), by defining in paragraph (a) everything *included* in salary and defining in paragraph (b) everything *excluded* from salary.¹⁹⁶ However, there again was nothing the 1993 amendments that appeared to exclude employer-paid deferred compensation.

No version of Minn. Stat. § 353.01, subd. 10, has ever contained an explicit exclusion of employer deferred compensation contributions from PERA salary.¹⁹⁷ However, in 1994, the legislature added language to Minn. Stat. § 353.01, subd. 10(b), that first raised a question of whether employer deferred compensation payments were excludable from PERA salary. At that time, the legislature added an explicit exclusion of “employer-paid amounts used by an employee toward the cost of insurance coverage, employer-paid fringe benefits, flexible spending accounts, cafeteria plans.” To paragraph (b).¹⁹⁸ Thus, to arrive at a conclusion that employer-paid deferred compensation is excludable from PERA salary, one must necessarily interpret the terms “employer-paid fringe benefits, flexible spending accounts, [and] cafeteria plans” as implicitly embracing employer-paid deferred compensation. None of those three terms is defined in Chapter 353 or any other chapter of Minnesota Statutes. The question therefore became whether or not the legislature intended “employer-paid fringe benefits, flexible spending accounts, and cafeteria plans” to include employer deferred compensation payments.

There does not appear to be a clear consensus of everything that could be a term “fringe benefit.” However, the term generally appears to mean something of value, other than current wages or salary, which an employee receives in consideration of employment. Many kinds of fringe benefits are valuable to employees because they involve favorable income tax treatment. In that light, deferred compensation contributions are generally considered to be fringe benefits because the payments made into them are not subject to income taxation “until they are distributed from the plan or made available to the participant or beneficiary.”¹⁹⁹ In other words, deferred contributions are “deferred,” and not “current,” compensation or wages. Under that analysis, both employer and employee deferred compensation contributions could be “fringe benefits.”

Since deferred compensation can be reasonably characterized as a fringe benefit, the question arose for the first time whether “deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs” only embraced *employee* deferred compensation deductions. What became ambiguous was the term “voluntary.” One possible interpretation is that “voluntary” refers to the payment being made. Thus, an employee’s contribution could be considered “voluntary” because in most deferred compensation plans, the employee

¹⁹⁶ Finding 34.

¹⁹⁷ See *generally* Findings 28 through 36.

¹⁹⁸ Finding 35.

¹⁹⁹ Ex. 5, p. 3-11.

has discretion whether to make a contribution, and if so, how much, but the employer's contribution could be considered "involuntary" because it is normally required by a CBA or other governing compensation plan.²⁰⁰ However, another possible interpretation of "voluntary" is that it simply refers to the "program" as a whole. In other words, another reasonable interpretation is that the employer and employee deferred compensation contributions are both parts of a "voluntary program" to reduce current income taxes by deferring the taxable event into the future, both contributions are includable in PERA salary.²⁰¹ However, it is unnecessary to determine which interpretation of Minn. Stat. § 353.01, subd. 10, is correct in order to decide whether PERA's policy to exclude employer contributions to deferred compensation plans from PERA salary is an unadopted interpretive rule. It is sufficient to establish that reasonable minds can differ on whether the legislature intended to include or exclude such payments, and that the statute is therefore ambiguous on that point.

D. PERA's interpretation that Minn. Stat. § 353.01, subd. 10(b)(2), excludes employer contributions to deferred compensation plans from PERA salary does not qualify as a long standing interpretation.

Because Minn. Stat. § 353.01, subd. 10(b)(2) is ambiguous about whether employer-paid deferred compensation should be treated as PERA salary, PERA's interpretation that such payments are not PERA salary, even if correct, can be applied only if that interpretation is a long standing one. PERA's asserts that its Executive Director has consistently interpreted Minn. Stat. § 353.01, subd. 10(b)(2), as excluding employer-paid deferred compensation as salary, and that PERA Staff has, in fact, been excluding such payments from treatment as PERA salary "dating prior to 1995."²⁰² That assertion was not challenged, and the ALJ accepts it at face value, even though the testimony established that PERA accepts the salary reports of participating employers at face value and merely assumes that they correctly reflect applicable law.²⁰³ The problem is that from 1995 until the July 31, 2007, email communication to the City, there was only one written expression of that interpretation and policy to a single participating employer—namely, an email to the City of St. Paul in 2004. Moreover, a handwritten notation on that email suggest that PERA's interpretation of Minn. Stat. § 353.01, subd. 10(b)(2) was never even clearly and unambiguously communicated to PERA Staff.

PERA recently responded to audit finding by the Legislative Auditor that PERA has had "an extensive training program that includes online information, employer handbooks, quarterly newsletters and training sessions throughout the state." However, between 1993 and 2008 PERA's Reporting Manual for participating employers and periodic newsletters to employers and members described amounts excluded from

²⁰⁰ This is the way that PERA now interprets the statute. See , e.g., Memorandum of Law in Support of PERA's Motion for Summary Disposition dated December 31, 2009, (PERA's Summ. Disp. Mem.) at p. 15.

²⁰¹ See further discussion in Part V, below.

²⁰² PERA Post-Hrg. Mem.) at pp. 13-14, citing Ex. 14 and Ex. 20.

²⁰³ Finding 25.

treatment as PERA salary. But in every such document placed into evidence PERA merely quoted the statutory language that “[e]mployer-paid fringe benefits, flexible spending accounts, [and] cafeteria plans” were not salary subject to PERA withholding.²⁰⁴ Prior to July 31, 2007, PERA never once explicitly stated in a written communication disseminated generally to participating employers or members that employer-paid deferred compensation contributions were not subject to PERA withholding or that that was PERA’s interpretation of governing legislation.²⁰⁵

Cheryl Keating, the Manager of PERA’s Account Information Management Division testified that it was her recollection that since 1992, PERA Staff had occasionally received oral inquiries from participating employers about whether employer deferred compensation payments were to be reported as PERA salary. She further testified that those employers were told that those amounts were not PERA eligible salary.²⁰⁶ Yet she could only find a written record, together with a written response from PERA, of only one such inquiry. That was an email inquiry from the City of St. Paul in 2004 together with PERA’s letter response.²⁰⁷ PERA’s copy of that city’s email message provides an insight into the consistency and clarity with which PERA communicated its interpretation of Minn. Stat. § 353.01, subd. 10(b)(2) to its own staff. The staff member who received the email commented in a handwritten note to another staff member: “You have an opinion? Just seems like a standard employer deferred comp. match and not PERA-eligible to me.”²⁰⁸ That notation raise an inference that PERA Staff were left to draw their own conclusions about what was excludable from PERA salary. It also gives credence to the assertion of Jackie Morris, the City’s Payroll Manager, that a PERA Staff member whom she consulted in about August 2007 agreed with her own view that the City’s deferred compensation payments should be treated as PERA salary.²⁰⁹

There was no evidence of how many oral inquiries on this subject have ever been made. Moreover, there is not even evidence that PERA ever communicated that interpretation to its own staff in written form. In *Cable Communications*,²¹⁰ the Minnesota Supreme Court denied long standing status of an agency interpretation of its governing legislation that the agency had never before formally asserted in a rule or in a contest case proceeding.²¹¹ PERA’s history of communicating and applying the interpretation at issue here falls far short of that. Neither MSRS nor TRA exercised rulemaking authority to resolve any statutory ambiguity and definitively establish that employer-paid deferred compensation was to be excluded from salary when calculating retirement benefits. However, in 1995 MSRS sought and obtained statutory clarification in lieu of adopting a rule,²¹² and in 1992 TRA established the existence of a long

²⁰⁴ Finding 48; see also Findings 45, 46, 47, 49, 50, and 51.

²⁰⁵ *Id.*

²⁰⁶ Tr. pp. 136-37.

²⁰⁷ Findings 53 , 54, 55, and 56.

²⁰⁸ Finding 55.

²⁰⁹ Finding 92.

²¹⁰ *Supra* at n. 189.

²¹¹ 356 N.W.2d at 667.

²¹² Findings 38 and 39.

standing interpretation to that effect by issuing written guidance to *all* of its participating members.²¹³ PERA did none of those things and, as a consequence, has been improperly enforcing an unadopted interpretive rule. At best, PERA's interpretation that Minn. Stat. § 353.01, subd. 10(b)(2) excluded employer-paid deferred compensation was almost exclusively communicated orally to a few participating employers and then only if and when specific inquiries were received.

Although not dispositive of this case, *In the Matter of the MnDOT Detroit Lakes Regional Headquarters, Construction Project Number 00TZ1791B*,²¹⁴ is instructive. There, the Departments of Labor and Industry and Transportation argued that a series of informal wage classification determinations made by their investigators to establish long standing regulatory policies. In rejecting that position, the ALJ observed:²¹⁵

[T]he Minnesota appellate courts have held that it is simply not appropriate to authoritatively determine questions as to which there is widespread social or political interest, through case-by-case adjudication.²¹⁶ The reasons are obvious. Persons interested in, or affected by, those determinations, might not have fair notice that a policy affecting their interests is being developed.²¹⁷

* * *

The ALJ further concluded:²¹⁸

[I]mplicit in the recognition of case-by-case adjudications as an alternative to notice and comment rulemaking, is that any incremental development of policy will involve similar formality. It simply cannot be that the occasional electronic mail message from Mr. Oelcker, or notes from a telephone consultation with Ms. Drier, has the same regulatory significance as rules promulgated by the agency following notice and comment rulemaking. As the record in this case makes clear, such writings do not contain the "principles of law or policy lawfully declared by the agency as the basis for its decisions in particular cases" and they are not maintained by either MnDOT-OCIC or DOLI so as to permit interested persons to petition for conversion of these informal writings into formal rules. A conclusion that senior labor investigators could add to the classification rules in this way does considerable violence to the scheme established by the Minnesota Legislature in Chapter 14. As the Minnesota Supreme Court has written:

²¹³ Finding 43.

²¹⁴ OAH No. 8-3001-17706-2, September 28, 2009.

²¹⁵ At p. 43.

²¹⁶ Citing, *Dullard v. Minn. Dep't of Human Servs.*, 529 N.W.2d 438, 445-46 (Minn. App. 1995); *In the Matter of the Appeal of Donald Jongquist*, 460 N.W.2d 915, 917 (Minn. App. 1990); *In the Matter of the Application of Crown CoCo*, 458 N.W.2d 132, 138 (Minn. App. 1990); ___.

²¹⁷ Citing, *In the Matter of the Application of Crown CoCo*, 458 N.W.2d at 138; *Hibbing Taconite*, 431 N.W.2d at 894.

²¹⁸ At p. 45.

The purpose of the Administrative Procedure Act is to ensure that we have a government of law and not of men. Under that act, administrative officials are not permitted to act on mere whim, nor their own impulse, however well intentioned they might be, but must follow due process in their official acts and in the promulgation of rules defining their operations.²¹⁹

In view of the above, the ALJ concludes that PERA's interpretation that Minn. Stat. § 353.01, subd. 10(b)(2), excludes employer-paid deferred compensation contributions does not qualify as a long standing agency interpretation of the statute that exempts PERA from formally promulgating that interpretation as an interpretive rule.

E. An agency interpretation of an ambiguous statute that is not a long standing interpretation is unenforceable

In *White Bear Lake Care Center, Inc. v. Minnesota Department of Public Welfare*,²²⁰ the Minnesota Supreme Court explained the consequences of failing to adopt an interpretive rule in formal rulemaking procedures:

The challenged practice is clearly within the statutory definition of a 'rule': '[E]very agency statement of general applicability and future effect, including the amendment, suspension or repeal thereof, made to implement or make specific the law enforced or administered by it or to govern its organization or procedure.' Minn.Stat. § 15.0411, subd. 3 (1980). Rules must be adopted in accordance with specific notice and comment procedures established by statute, Minn.Stat. § 15.0412 (1980), and the failure to comply with necessary procedures *results in invalidity of the rule*.²²¹ [Emphasis supplied.]

In 2001, the legislature enacted Minn. Stat. § 14.381, which approved the result in *White Bear Care Center* and in other appellate cases by creating a remedy to prevent agency attempts to "to enforce a policy, guideline, bulletin, criterion, manual standard, or similar pronouncement as though it were a duly adopted rule." Subdivisions 1 and 2 provide:

Subdivision 1. **Petition.** (a) A person may petition the Office of Administrative Hearings seeking an order of an administrative law judge determining that an agency is enforcing or attempting to enforce a policy, guideline, bulletin, criterion, manual standard, or similar pronouncement as though it were a duly adopted rule. The petition must be supported by affidavit and must be served upon the agency. The agency shall respond

²¹⁹ Citing, *Monk & Excelsior, Inc. v. Minn. State Board of Health*, 225 N.W.2d 821, 825 (Minn. 1975); accord, *Jongquist*, 460 N.W.2d at 917.

²²⁰ 319 N.W.2d 7 (Minn. 1982).

²²¹ *Id.* at 8-9; citing, *Johnson Brothers Wholesale Liquor Co. v. Novak*, 295 N.W.2d 238 (Minn.1980).

in writing to the petition within ten working days. The administrative law judge may order oral argument on the petition, but only if necessary to a decision.

(b) An agency determination is not considered an unadopted rule when the agency enforces a law or rule by applying the law or rule to specific facts on a case-by-case basis.

Subd. 2. **Order.** The order of the administrative law judge must direct the agency to cease enforcement of the unadopted rule that is the subject of the petition. The order must be served upon the parties and the legislative coordinating commission by first class mail and must be published by the agency in the State Register. The decision of the administrative law judge may be appealed under sections 14.44 and 14.45.

In summary, the law is clear. The interpretation of Minn. Stat. § 353.01, subd. 10, that PERA has applied to the Petitioners is an interpretive rule that is invalid because it has not been promulgated in accordance with the Minn. Stat. Ch. 14. PERA's subtraction of the City's deferred compensation payments from the PERA salary amounts of City employees should be reversed.

V. The ALJ concludes that PERA's interpretation that Minn. Stat. § 353.01, subd. 10, excludes employer deferred compensation payments correctly resolves the statutory ambiguity.

As discussed above, between 1973 and 1994, Minn. Stat. § 353.01, subd. 10, necessarily included both employee and employer contributions because there was nothing in the statute that could reasonably be construed as excluding employer deferred compensation payments.²²² That changed in 1994 when the legislature added an explicit exclusion of "employer-paid fringe benefits." However, one could still reasonably argue that the resultant possible exclusion of employer deferred compensation contributions from PERA salary was an unintended consequence of the amendment and not the legislature's actual intent. However, something else the legislature did in its 1994 session reduces the persuasive force of that argument.

In 1994, the legislature established a Salary Study Committee comprised of legislators and representatives from the Legislative Pension Commission and the state public pension plans.²²³ That study committee included representative from the Minnesota State Retirement System (MSRS) and PERA.²²⁴ One of the issues that the Committee addressed was whether employer matching contributions to MSRS' deferred compensation program should be considered salary for purposes of calculating MSRS

²²² See discussion in Part IV-B, *supra*.

²²³ Finding 37.

²²⁴ Ex. 20 (at Ex.A).

benefits.²²⁵ Among other recommendations, the Committee’s specifically concluded that employer contributions to the MSRS deferred compensation program:

[s]hould not be included as salary. Generally, employer contributions are not considered salary, stopping deductions on employer paid deferred compensation amount would be consistent with this philosophy.²²⁶

The Committee then recommended that the definition of salary in MSRS’ governing legislation—Minn. Stat. § 352.01, subd. 13—be amended to state “employer contributions to a deferred compensation or tax sheltered annuity program, and amounts contributed under a benevolent vacation and sick leave donation program are not salary.”²²⁷ The 1995 legislature accepted that recommendation and enacted that amendment to Minn. Stat. § 352.01, subd. 13. What is puzzling is that, despite PERA’s participation on the Committee, there was no recommendation for a similar amendment to Minn. Stat. § 353.01, subd. 10(b). One could view that as an oversight. However, one could also view that as an expression of legislative intent not to exclude employer-paid deferred compensation from PERA salary.²²⁸ In fact, the City of St. Paul specifically mentioned the absence of an explicit exclusion of employer-paid deferred compensation in Minn. Stat. § 353.01, subd. 10(b) when it asked for PERA’s interpretation of the statute in 2004.²²⁹

Determining the scope of the legislature’s intent in excluding employer-paid fringe benefits from PERA salary in 1994 is difficult, and is something about which reasonable minds can differ. However, the Study Committee’s conclusion that employer deferred compensation contributions were generally “not considered salary,” and that “stopping deductions on employer paid deferred compensation amount would be consistent with [that] philosophy” indicates that the legislature’s failure to recommend a commensurate amendment to Minn. Stat. § 353.01, subd. 10, in 1995 was most likely an oversight, and that it intended both that subdivision and Minn. Stat. § 352.01, subd. 13, to be interpreted in the same way. Therefore, for the reasons discussed above, the ALJ agrees with PERA’s interpretation that employer deferred compensation payments fall within Minn. Stat. § 353.01, subd. 10(b)’s definition of “fringe benefit,” and that, taken as a whole, the statute excludes such payments from treatment as PERA salary.²³⁰ However, even though PERA’s resolution of the statutory ambiguity may be correct, the agency cannot enforce it against City employees if that interpretation is not a long standing one.²³¹

²²⁵ Ex. 37.

²²⁶ Ex. 38.

²²⁷ *Id.*

²²⁸ For example, a material difference might have been that MSRS was the sole provider of deferred compensation plans for state employees, while there were a variety of such plans available to employees of political subdivisions.

²²⁹ See Finding 55.

²³⁰ As discussed above, the fact that PERA’s interpretation of an ambiguous statute may be correct does not excuse it from failing to communicate its interpretation to participating employers and members. See discussion in Part IV, *supra*.

²³¹ *Mapleton Community Home, supra*, 391 N.W.2d at 801).

VI. PERA's Benefit Recalculations Were Based on Inaccurate PERA Salary Information

Nonetheless, even if PERA's interpretation of Minn. Stat. § 353.01, subd. 10(b), were to be considered both correct and enforceable, the revised PERA salary information that the City provided to PERA included large amounts of deferred compensation payments on which income taxes were paid and which were therefore properly treatable as PERA salary. As a consequence, PERA's recalculations of the Petitioners' retirement benefits underestimated their PERA eligible salaries and were inaccurate, in part.

A. Whenever the City included its deferred compensation payments in employees' taxable income, those payments became current wages.

As discussed above, the benefit to employees inherent in many common fringe benefits is favorable income tax treatment. In fact, "deferred compensation" is a term that draws its existence from income tax consequences. Put another way, the term deferred compensation has no meaning without reference to federal and state income tax laws:

Withholding on Section 457 Plans

Amounts deferred into an eligible section 457(b) deferred compensation plan are not subject to income tax withholding until they are distributed from the plan or made available to the participant or beneficiary. * * *²³²

The evidence established that the deferred compensation plans maintained by individual City employees were established under section 457 of the Internal Revenue Code and were intended to be administered as such.²³³ However, the evidence also established that on numerous occasions from 1995 to August 1, 2007, the City's payroll system mistakenly caused the Petitioners and other City employees to pay income taxes on the City's deferred compensation contributions at the time when those contributions were made, rather than allowing income taxation to be deferred until the benefits were later distributed.²³⁴ When that occurred, in both a practical and legal sense those City payments lost their character as "fringe benefits" within the meaning of Minn. Stat. § 353.01, subd. 10(b)(2) and became current "salary" or "wages" within the meaning of Minn. Stat. § 353.01, subd. 10(b)(2).

PERA takes the position the tax consequences of the City's payments are not within PERA's purview, and that the tax treatment of those payments is immaterial.²³⁵ In effect, it argues that the fact that the City's payroll system called those payments "deferred compensation" is sufficient to require their exclusion. However, excluding those payments from PERA salary for that reason exalts form over substance.

²³² Ex. 5 at p. 3-11.

²³³ Finding 70.

²³⁴ Findings 103 through 117.

²³⁵ PERA Post-Hrg. Mem. at p. 18; PERA's Reply Memorandum at p. 1; Tr. p. 133.

Employee-paid deferred compensation benefits are “fringe benefits” only if they are made in such a way that employees only pay income taxes on them at when deferred compensation is withdrawn from the plan. In other words, if employees pay income taxes on them at the time the employer pays them into a deferred compensation plan, income taxation is no longer deferred, and the payments are no longer “fringe benefits” in any reasonable sense of that term. When the City’s deferred compensation payments were prematurely included in employees’ taxable income at the time the payments were disbursed, they were no longer *deferred* compensation and became *current* “wages” within the meaning of Minn. Stat. § 353.01, subd. 10(a). The State Auditor’s staff may well had had that in mind when it resolved the audit finding that the City’s deferred compensation payments violated Minn. Stat. § 356.25. The City’s deferred compensation contributions were being taxed when made and therefore became current wages for employees. When those contributions were directed into employee deferred compensation plans, they could therefore have been seen as *employee*, rather than employer, contributions and not a violation of Minn. Stat. § 356.25.

B. The City’s insurance supplement payments were PERA salary even when they were subject to income taxes when made.

Like deferred compensation, employer-paid medical insurance is generally recognized as a “fringe benefit.” Under the City’s CBAs with its employees, an employee could direct a specified monthly City payment either to a deferred compensation plan or toward the cost of family medical insurance coverage.²³⁶ The evidence established that between 1995 and August 1, 2007, like the City’s deferred compensation contributions, insurance supplement payments to employees were frequently included in the employees’ taxable income and taxed.²³⁷ The question therefore is whether insurance supplement payments that were immediately subject to income tax should also be treated as current salary or wages.

As discussed above, the ALJ has concluded that employer deferred compensation payments are also a fringe benefit within the meaning of Minn. Stat. § 353.01, subd. 10(b)(2), and are therefore excluded from treatment as PERA salary. However, the defining characteristic of deferred compensation and what makes employer-paid deferred compensation a fringe benefit is deferred income tax treatment. In fact, the only thing that distinguishes current wages from employer deferred compensation payments is the difference in income tax treatment. Current wages are subject to income tax at the time they are paid, and employer deferred compensation payments are not taxed until later on when the employee withdraws funds from the plan. In short, when employer-paid deferred compensation’s defining characteristic—deferred income tax treatment—is eliminated, the payment simply becomes current wages

However, a similar analysis of the City’s insurance supplement produces a different result with respect to consequences of tax treatment. Unlike employer-paid

²³⁶ Findings 74-81.

²³⁷ Findings 108, 111.

deferred compensation, what distinguishes employer insurance payments is the restrictions on their use, and not their income tax treatment. Unlike current wages, which an employee can use for any purpose, employer insurance payments can only be used to purchase insurance and nothing else. Employees normally have the option of treating employer medical insurance payments as a pre-tax benefit or having them income taxed when made and deducting them as medical expenses. However, regardless of their income tax treatment, they remain employer insurance payments that are explicitly excluded from PERA salary by Minn. Stat. § 353.01, subd. 10(b)(2). For example, if by contract the City were to eliminate that defining characteristic—that is, the restriction of their use to the purchase of insurance, then those payments would also become current wages. But nothing like that happened here.

Because employer insurance payments give an immediate financial benefit to employees in consideration of their employment, one could possibly argue that they also represent a form of current compensation or wages. But even if that view were correct, the legislature has, as a matter of policy, expressly excluded certain types of compensation from treatment as PERA salary. Among them are:

(b) Salary does not mean:

(1) the fees paid to district court reporters, unused annual vacation or sick leave payments, in lump-sum or periodic payments, *severance payments, reimbursement of expenses, lump-sum settlements not attached to a specific earnings period*, or workers' compensation payments;

(2) *employer-paid amounts used by an employee toward the cost of insurance coverage ...* [Emphasis supplied.]

VII. PERA must recalculate City employee retirement benefits using more accurate PERA salary information.

PERA bears the burden in this proceeding of establishing by a preponderance of the evidence that the recalculations of the Petitioners' retirement benefits that PERA is proposing were accurate, and not erroneous, recalculations.²³⁸ The Represented Petitioners argue that because in 2005 the City eliminated much of its payroll detail from prior years from its computer system and did not save paper copies of that detail, all payroll information prior to January 1, 2005, the information that the City provided to PERA is completely unreliable and should not form a basis for any PERA's benefit recalculations. The ALJ disagrees, at least in part.

In recalculating the retirement benefits of City employees, PERA properly relied on any information that the City reported regarding past City insurance supplement payments as subtractions from previously-reported PERA salary.²³⁹ The evidence only established that the information that the City supplied about past deferred compensation

²³⁸ See Part I, *supra*.

²³⁹ Finding 113.

payments was demonstrably inaccurate because it included deferred compensation payments on which employees paid income taxes at the time the payments were made.²⁴⁰ There was no showing that the City's pre-2005 payroll data was materially erroneous in any other way. There is also the issue of PERA improperly subtracting all of the City's deferred compensation contributions by applying an unadopted interpretive rule. Therefore, the ALJ therefore concludes that it is only necessary for PERA to again recalculate the retirement benefits if City employees based by including all or some employer deferred compensation payments as PERA salary.

It is not the duty or obligation of the Petitioners to come forward with more accurate payroll information. Rather, the City has a statutory responsibility to provide accurate salary information to PERA.²⁴¹ Although it may require a lengthy audit, Mr. Parson testimony established that the City has the ability to provide PERA with accurate information on the corrected PERA salary of its employees during the period from January 1, 2005, to August 1, 2007, and PERA should require the City to do so.²⁴² However, it appears to be no longer possible for the City to provide PERA with accurate PERA salary information for its employees during the period from January 1, 1995, through December 31, 2004.²⁴³ Although Minn. Stat. § 353.27, subd. 11(b) allows PERA to estimate the obligations of employers and employees based on the records that are available, it would be arbitrary and capricious and an abuse of statutory discretion for PERA to recalculate Petitioners' retirement benefit based on demonstrably inaccurate information. Some of the Petitioners retained paystubs from that period. A reasonable approach to establishing more correct PERA salary information for City employees might be for PERA to require the City to recalculate correct PERA salary information for the earlier years based on such paystubs as may still be available. PERA could then apply the percentage of correct PERA salary information established by those available paystubs for the period from January 1, 1995, through December 31, 2004, to the corrected PERA salary for all employees and all pay periods that the City previously reported for that period.

VIII. Conclusion

The ALJ concludes that no statute of limitations prevents PERA from recalculating the retirement benefits of City employees, and that the doctrines of promissory and estoppel do not prevent PERA from recalculating the Petitioners' retirement benefits or from collecting overpayments from the Petitioners and other City employees. On the other hand, PERA's interpretation that Minn. Stat. § 353.01, subd. 10, excludes employer-paid deferred compensation is an interpretive rule, which does not qualify as a long standing interpretation and which was not promulgated in accordance with the Minn. Stat. Ch. 14. That interpretation therefore cannot be applied to the Petitioners and other City employees and used in recalculating their retirement benefits. Additionally, a preponderance of the evidence established that the City

²⁴⁰ Findings 103-114, 117.

²⁴¹ Minn. Stat. §353.27, subd. 4.

²⁴² Findings 100, 114.

²⁴³ *Id.*

deferred compensation payments were frequently taxed as income when those payments were made. Whenever that occurred, those payments were no longer excludable fringe benefits but rather became current wages. That is an additional reason why PERA must again recalculate the retirement benefits of City employees using more accurate information and estimates of PERA salary. Although there may be significant difficulties involved with arriving at reasonable estimates of PERA salary for the period 1995 through December 31, 2004, those difficulties are not insurmountable. Moreover, PERA should place most of the burden of arriving at more reasonable estimates on the City, where it statutorily belongs.

B. H. J.