Firehouse Lawyer

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Inside This Issue

Firefighters' Suit Leads to Landmark Supreme Court Reverse Discrimination Ruling

The city of New Haven, Connecticut, threw out the results of a promotional exam given to firefighters because of its concern that not enough minorities had passed the test. The city's action was apparently the result of an affirmative action policy designed to remedy perceived past discrimination against racial minorities. Since the 1960's affirmative action policies of this nature have become rather common in fire departments and other public employment settings, despite criticisms from some quarters, alleging that such race-conscious policies are themselves discriminatory.

In New Haven, a group of white firefighters and one Hispanic firefighter who passed the test sued the city, claiming that the city's action in throwing out the test discriminated against them based on their race. The U.S. Supreme Court agreed, in a 5-4 decision, and announced a new standard for courts to follow. The razor-thin majority ruled that, when the two employment discrimination standards conflict with one another—disparate impact and disparate treatment—a "strong basis in evidence" standard will be applied.

By way of background, disparate *impact* refers to those situations when a hiring practice or rule has the unintended consequence (impact) of treating minorities worse than others, i.e. discriminating. By contrast, disparate *treatment* means the actual or intentional use of race (for example) as a factor in making a hiring decision. In this case, when the city intentionally threw out the test, it was treating the white and Hispanic firefighters in a discriminatory way, so that would be a disparate treatment case. As you can see, the city was somewhat on the horns of a dilemma. It ran the risk, if it did not throw out the test of a disparate impact claim by the racial minorities who could not pass the test. On the other hand, by throwing out the test, it ran the risk of the disparate treatment case that was filed (successfully, as it turned out) by the non-minorities who passed the test.

Under the newly enunciated standard, before an employer can intentionally discriminate like this in order to prevent a perceived disparate impact, or to achieve an affirmative action result, the employer "must have a strong basis in evidence to believe it will be subject to disparate-impact liability if it fails to take the race-conscious, discriminatory action." See *Ricci v. DeStefano,* 557 U.S. _____ (2009).

We predict that this standard will lead to more discrimination litigation due to the vagueness of that standard. It will take actual decisions by the U.S. District Courts (federal trial courts) and the Circuit Courts of Appeal to flesh out the meaning of this standard, with real-world fact situations. I would think that municipal fire departments would be more reluctant than ever to make race a factor in making employment decisions. This may be quite a shame in those departments where blacks and other minorities are clearly under-represented in the departments, while at the same time being a large percentage of the population in that area. But of course in some areas, while there may not be very many minority firefighters, there are also not many of that particular minority in the community either, so in those cases affirmative action is unlikely to really work. That is why I think it will take more actual cases to show us what this new standard will really mean out there in the field. My suspicion is that it will strongly depend on the facts of the case. After all, the new standard – "a strong basis in evidence"—is by its nature *factual*, is it not? The other problem is that the decision was reached only by a narrow 5-4 margin and so the rule can change again with anticipated changes on the Court.

Oh, by the way, we might mention that the Circuit Court panel that they overruled included Judge Sonia Sotomayor. Not too long after announcement of this decision, the Senate approved President Obama's nomination of Judge Sotomayor to the Supreme Court. So…the beat goes on.

ANOTHER DISCRIMINATION CASE – PERHAPS A NO-BRAINER

A Montana firefighter was rejected for hiring by a local fire department because of a state law prohibiting the original appointment of firefighters older than 34 years of age. Following testing and interviews, the plaintiff tied for second on the hiring list. Upon the chief executive's recommendation, the county commissioners approved the placement of the top three candidates on the hiring list. When a position opened in May 2005, the #1 candidate was appointed, and when the next opening came in June 2005, the plaintiff was by then 35 years old but the person who tied with him for second was still 34 years old. The chief executive, after consulting legal counsel, decided the plaintiff was ineligible due to the aforementioned state statute, and then the fun began. The plaintiff sued, claiming age discrimination and asserting that the state law was unconstitutional.

Ultimately, the Montana Supreme Court agreed with plaintiff, ruled that the statute is unconstitutional, but afforded him no practical relief, finding that the county did not act with malice or corruption, but relied on state law in good faith. The Court pointed out that firefighters in their 50's can perform their functions competently and this demonstrates the age limitation is without any rational basis, or is not rationally related to the statute's objective. Therefore, the Court found no factual or empirical basis for drawing a cut-off point at 34 years of age for the initial appointment. Obviously, if firefighters older than 50 can perform competently, the argument is even stronger for firefighters in their late 30's. Thus, I would argue it is also presumptuous to conclude that a person must want to work in the occupation for some arbitrary length of time such as a minimum of 15-20 years. A person might want to change occupations at age 35 and only work for 5-10 years as a firefighter; I do not believe it is appropriate to deny such person a chance due to their age either. It seems to me that the Montana Supreme Court's decision was clearly right; the only unfortunate part is that the plaintiff was denied a remedy.

ANOTHER GUEST COLUMNIST – SCOTT JOHNSON OF TRIBECA ADVISORS

Fire District Retirement Plans Could Be Vastly Improved

What if you could significantly improve your retirement plan in a way that would vastly increase the retirement benefits to you, your fire fighters, your staff and their families? Wouldn't you want to pursue how this can be done? If you read on, you'll learn how.

As a Chartered Retirement Plans Specialist who has spent the past decade serving the retirement plan industry, I have learned a great deal about what makes a retirement plan successful. If you are a Trustee of your Fire District's 457 Deferred Compensation Plan, or simply a participant, I'd like to share my thoughts with you.

Plan Costs and Fees Really Do Matter

If you only remember one cardinal rule about your retirement plan, this is it: **The single best thing you can do to improve your retirement plan is to lower overall expenses.** Unfortunately, most of the 457 plans utilized by Washington State Fire Districts have significant excess fees which silently rob your plan of its potential return. According to a recent Congressional study, if your 457 plan has excess fees of just 0.5% per year, you need to work an additional 16 months to receive the same monthly retirement income. If your plan has 2.0% annual excess fees, you would need to work an additional 64 months. Imagine the best five years of your "retirement" spent working because you have a retirement plan with excess fees!

Most of the Fire District 457 plans in Washington State utilize group annuity products with inherently high fee structures. In addition to high mutual fund expense ratios, insurance "wrap" fees, and surrender charges, many of these plans also have hidden fees that most participants and plans sponsors are not aware of. A recent analysis we conducted of a Pierce County Fire District retirement plan with approximately $15 million in assets found that they were paying approximately 0.68% in excess annual fees. Such excess fees will reduce their retirement accounts by about 15% over time. For smaller Fire District plans, this percentage is likely to be much higher. Pension attorney Devitt Barnett of the Seattle firm of Thorson Barnett & McDonald, P.C., who works with a number of Fire Districts throughout the state [We have referred several clients to Mr. Barnett over the years-*Ed.]*, has said the following:

"**Many of the 457 Plans we see are funded through group annuity contracts and should be carefully reviewed for performance under a 'risk-vs.-return' standard. Careful attention should be placed on reviewing the overall fee structure of the annuity product as compared to other non-annuity investment options**."

Index Funds are a Better Choice

Understanding the difference between actively managed mutual funds and passively managed mutual funds could literally add hundreds of thousands of dollars to the retirement accounts of your employees over their working lives. By definition, "actively managed" funds attempt to beat their target market benchmark, like the S&P 500 Index, by researching and trading individual stocks or bonds. "Passively managed" funds, like index funds, simply track market averages by buying and holding securities to match their target index. According to Morningstar, the average actively traded mutual fund has an expense ratio of 1.50%. The average passively managed fund has an expense ratio of 0.30%. This difference in expenses is why passively managed funds nearly always outperform actively managed funds over the long term.

In the most comprehensive study ever conducted and published in 2008 ("False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas" May 2008), the investment performance of every actively traded fund in existence between 1975 and 2006 was analyzed. The researchers found that after expenses, only 0.6% (less than one fund in 160) of actively managed mutual funds outperformed the market. In its review of this study on July 13, 2008, The New York Times concluded:

"Index funds are the only rational alternative for almost all mutual fund investors…"

Unfortunately, the majority of insurance based, group annuity plans utilized by Fire Districts offer no passively managed mutual fund options. As a result, fire fighters are paying higher fees for underperforming funds.

Investment Portfolios vs. Individual Funds

For the past 20 years, retirement plan providers have convinced plan sponsors that the more investment choices you put into your plan, the better. In reality, this advice has had more to do with Wall Street lining its own pockets than the best interest of plan participants. One Pierce County Fire District plan had 65 investment options – the most we have ever seen! Unfortunately, too many choices can "paralyze" plan participants, and actually *reduce* your net retirement benefits.

All of us, even investment professionals like myself, are subject to human emotion when it comes to investing. Given many investment choices, retirement plan investors tend to "actively manage" their accounts. Unfortunately, in the process, they often make three common mistakes that cause their investments to underperform the market:

1) **Chasing returns** – moving money into the fund with the best recent performance.
2) **Timing the Marke**t – moving money from stocks to bonds to cash based on economic headlines.
3) **Misallocation** – putting all your eggs in one basket, or the wrong basked based on your age and years to retirement.

A John Hancock study (of 14,487 plan participants from 1997-2006) found that the average participant who did not utilize a professionally managed portfolio had the following characteristics:

- **Lack of Diversification**: The average number of funds selected was 3.9.
- **Lack of Discipline**: Participants tended to allocate their balances to popular funds at the time of their enrollment and made few changes afterwards (such as systematic rebalancing).
- **An Unbalanced Approach**: Participants tended to allocate their accounts at opposite ends of the risk spectrum (conservative or aggressive) rather than taking a more balanced approach.

Another recent study by DALBAR Financial Services paints an even bleaker picture for plan participants who choose their own funds. The study tracked investor's behavior in chasing market returns from 1987-2006. Over this twenty year period, the S&P 500 yielded 11.8% per year while the average investor only earned 4.3%.

The takeaway from these studies is this: **Fire Districts would significantly increase their investment success by offering low cost, diversified, passively managed mutual fund portfolios instead of large menus of actively managed mutual funds.** An illustration of this is the Fire District plan with the 65 investment options. When we compared the performance of those funds against a balanced (60% equities/40% fixed income) portfolio of passively managed mutual funds with an expense ratio of 0.30%, only four (4) of the 65 funds beat the balanced portfolio over the short term (1 year) and only seven (7) beat the balanced portfolio over the long term (10 years). None of the 65 funds beat the balanced portfolio over all 1, 3, 5, and 10 year periods.

Fiduciary Advisor vs. Insurance Broker

Doctors, lawyers, and CPAs are fiduciaries. They must act solely in the best interest of their clients. However, insurance agents and investment brokers are held to a lower standard called "suitability". As long as the investment is suitable for you, brokers can recommend it, even if it isn't the best choice for you. Traditional retirement plan brokers and advisors have divided loyalties: they must be loyal to clients, but also loyal to their brokerage firm. As a result, insurance based retirement plan providers and their advisors have shunned the fiduciary role and avoid dispensing individual investment advice to participants because of their conflict of interest.

Fire Districts and plan trustees would be wise to work with plan providers and advisors who willingly act as investment fiduciaries on your plan. Working with an investment fiduciary provides three huge benefits as follows: (1) using the services of an investment fiduciary reduces the fiduciary liability for plan sponsors and trustees; (2) since fiduciaries must put the interest of plan participants first, all investment decisions are made with the participants best interests in mind; and (3) fiduciaries can legally dispense individual investment advice to participants. How many times have you or a fellow participant come away from an investment meeting and said "But how should I allocate my account?" With an investment fiduciary on board, you can now ask that question and get an answer that is tailored to your needs.

Responsibility of Plan Trustees

If you are a member of your District's Retirement Benefits Committee then you do have a fiduciary duty to ensure that your plan costs are as low as possible and that all fees are transparent to your plan participants. According to attorney Devitt Barnett:

"Although 457 Plans are typically treated as 'governmental Plans', and are therefore exempt from federal laws under the Employee Retirement Income Security Act ("ERISA"), these Plans are subject to state law considerations that essentially require the same level of review and monitoring of their investment options and the fees associated with those options. The individuals and employees involved in determining which funds or investment options to offer in a 457 Plan are treated as 'fiduciaries' under applicable state and federal law, and have a duty to carry out their responsibilities in a prudent and diligent manner. Using the services of an independent investment advisor to assist the 457 Plan Committee with its duties is a wise choice."

Conclusion

If your Fire District is currently using a group annuity product for your retirement plan and you would like to explore ways to lower plan costs and increase the net retirement benefits of your employees, consider receiving a free plan analysis from Tribeca Advisors. Tribeca has partnered with Trautmann-Maher, one of the largest pension plan administrators and record keepers in the Northwest, to offer Fire Districts a low cost, fee transparent alternative to what most Districts are using now.

For a free analysis of your current retirement plan, please contact:
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