

The State of Texas
House of Representatives

RECEIVED

MAY 02 2008

OPINION COMMITTEE



BYRON COOK
STATE REPRESENTATIVE
DISTRICT 8

FILE # ML-45666-08

I.D. # 45666

COMMITTEES:
CHAIRMAN,
CIVIL PRACTICES
MEMBER,
STATE AFFAIRS

P.O. Box 2910
AUSTIN, TEXAS 78768-2910
512-463-0730
FAX: 512-463-2506
800-643-7026

April 30, 2008

The Honorable Greg Abbott
Attorney General of Texas
P.O. Box 12548
Austin, TX 78711-2548

RQ-0708-GA

Re: Request for opinion regarding reimbursing employee retirement funds lost because of fraud by a third party.

Dear General Abbott:

Pursuant to Government Code Section 402.043, I respectfully request your opinion on the question presented below.

Question:

May a Hospital District, established pursuant to Article IX, Section 9, of the Texas Constitution, replenish employee retirement funds embezzled by a third party administrator and accept assignment of such employees' claims against the third party administrator?

Background:

Gonzales Healthcare Systems (the "Hospital" or "District") was created by enabling legislation during the 64th Legislative Session by House Bill 1543. *Acts 1975, 64th Leg., p. 446, ch. 191, eff. Sept. 1, 1975.* The Legislature described the enabling legislation as, "An Act relating to the creation, establishment, administration, maintenance, operation, and financing of Gonzales County Hospital District¹ of Gonzales County, Texas, by authority of Article IX, Section 9, of the Texas Constitution; and declaring an emergency." *Id.*

Prior to 2002, the District had only a non-employer-matching variable annuity program with low participation. In an effort to improve employee retention and morale, the District requested proposals for a financial company to set up a new employer-matching retirement plan. On

¹ During the 75th Legislature, the Gonzales County Hospital District changed its name to Gonzales Healthcare Systems. *Acts 1997, 75th Leg., p. 3087, ch. 1002, eff. September 1, 1997.*

August 27, 2002, the District's Board of Directors approved a proposal for a new retirement plan (the "Plan"). IPoint Solutions, LLC ("IPoint"), owned by Barry Stokes, became third party administrator. Most District employees began contributing to the Plan shortly thereafter.

On September 26, 2006, a chapter 11 involuntary petition was filed in the bankruptcy court of the Middle District of Tennessee to force IPoint into bankruptcy. Involuntary bankruptcy was approved on September 27, 2006, and a trustee was appointed to secure the company's assets. The trustee determined that IPoints' clients' funds were commingled in a IPoint 401(k) account. The trustee further determined that funds in that account were transferred for the benefit of Barry Stokes. On October 13, 2006, the bankruptcy judge ordered the opening of chapter 11 bankruptcy for Barry Stokes, individually, and then consolidated the cases of both IPoint and its owner. On the same day, October 13, 2006, Barry Stokes was arrested for embezzlement from an employee benefit plan. At this point in time it appears that recovery through the bankruptcy process will be minimal, and that little, if any, of the employees' retirement funds will be recouped. In the interest of restoring the integrity of its employee retirement plan, the District would like to know whether it has the legal authority to replenish the lost employee funds and receive assignment of employee claims for such funds.

Legal Authority for the Creation of Gonzales Healthcare Systems and a Retirement Program:

The basis for the creation of the District is Article IX, Section 9, of the Texas Constitution. Pursuant to the above Section of the Texas Constitution, the Legislature passed the enabling legislation creating the District during the 64th Legislative session. *Acts 1975, 64th Leg., p. 446, ch. 191, eff. Sept. 1, 1975.* Section 1 of the Act states:

In accordance with the provisions of Article IX, Section 9 of the Texas Constitution, this Act authorizes the creation, establishment administration, maintenance, operation, and financing of a hospital district within this state, the boundaries of which shall include all of the land or territory in Gonzales County, Texas...to be known as Gonzales County Hospital District with such rights, powers, and duties provided in this Act. *Id.*

Legal Authority to Create Retirement Program:

The Texas Constitution provides general authority for a local government entity to create a retirement plan. This authority is found in Article XVI, Section 67 titled "State and Local Retirement Plans." Specifically, Article XVI, Section 67(f) allows for the creation of local retirement programs.

Although the District's enabling legislation does not directly address the establishment of a retirement plan for District employees, it provides broad authority that clearly encompasses creating a retirement program. The relevant Sections of the enabling legislation include the following:

Sec. 2. The district herein authorized to be created shall...provide for the establishment of a hospital system by the purchase, construction, acquisition, repair, and renovation of buildings and equipment, and equipping the same, and the administration thereof for hospital purposes [Emphasis added].

Sec. 5. The board of directors shall manage, control, and administer the hospital system and all funds and resources of the district, but in no event shall any operating, depreciation, or building reserves be invested in any funds or securities other than those specified in Article 836 or 837, Revised Civil Statutes of Texas, 1925, as amended. The district, through its board of directors, shall have the power and authority to sue and be sued, to promulgate rules and regulations governing the operation of the hospital, hospital systems, its staff, and its employees...The administrator or manager shall supervise the work and activities of the district and shall have general discretion of the affairs of the district, subject to the limitations as may be prescribed by the board...[Emphasis added].

Sec. 6. ...The board of directors shall have authority to make such changes in the budget as in their judgment the law warrants and the interest of the taxpayers demands....

Sec. 10(b). The board of directors of the district shall have the power to prescribe the method and manner of making all purchases and expenditures by and for the hospital district and shall also be authorized to prescribe all accounting and control procedures....Except as permitted in the preceding sentence and Sections 7, 8, and 9 of this Act, the district may incur no obligations payable from any revenues of the district, tax or otherwise, except those on hand within the then current and following fiscal year of the district.

Sec. 12(a)(2). The board of directors shall annually levy a tax not to exceed the amount permitted by this Act for the purposes of paying the maintenance and operating expenses of the district.

Sec. 21. In carrying out the purposes of this Act the district will be performing an essential public function.

Thus, the purpose of the statute is to allow the District to carry out the essential public function of providing health care to District residents. Hiring and retaining staff is necessary for the District's performance of its public function. Providing compensation, including retirement plans, is critical to hiring and maintaining able staff. Therefore, retirement plans are integral to the District meeting its public function.

Other statutes provide general authority for local government entities, including hospital districts, to maintain retirement plans. These include Government Code Chapter 609, titled Deferred Compensation Plans, and Tex. Rev. Civ. Stat. art. 6628a-5, titled Annuities or Investments for Certain Public Employees; Salary Reductions. Specifically, Tex. Rev. Civ. Stat.

art. 6628a-5(a)(9) and (b) allow county hospitals, city hospitals, city-county hospitals, hospital authorities, and hospital districts to:

enter into agreements with the entity's employees for the purchase of annuities or for contributions to any type of investment for the entity's employees as authorized in Section 403(b), Internal Revenue Code of 1986, and its subsequent amendments.

Legal Authority to Replenish Retirement Program Funds:

Providing an employee retirement program has long been common-place in the public sector, as evidenced by case law discussed below; it is an important part of public employee compensation and allows entities to hire and retain qualified staff. The loss of retirement funds due to embezzlement by a third party hampers a governmental employer's ability to carry out its public function. Fortunately, case law and other legal authorities support the District's ability to replenish the lost funds.

For example, in 1928 the Texas Supreme Court responded favorably to certified questions from the U.S. Fifth Circuit Court of Appeals regarding a local government retirement plan. *Byrd v. Dallas*, 6 S.W.2d 738 (Tex. 1928). One of the questions certified to the Court was whether a Dallas ordinance that appropriated from the general revenues one per cent of the combined salaries of policemen, firemen and fire alarm for city pension fund, was valid. The ordinance had been authorized by majority vote of Dallas voters, but was challenged as an improper use of public funds. *Id.* at 739. The Court held that the ordinance was valid, and the reasoning of the Court is instructive on the question raised in this Opinion Request. First, the Court outlined the Sections of the Texas Constitution that restrict the use of public funds, including Sections 51 – 53 of Article III, Section 3 of Article VIII, Section 6 of Article XVI, and Section 16 of Article 1.² *Id.* at 740. The Court interpreted these Constitutional provisions in a common-sense manner, stating:

Without discussing in detail these provisions of the Constitution, it is sufficient to say each of them is intended to prevent the application of public funds to private purposes; in other words, to prevent the gratuitous grant of such funds to any individual, corporation, or purpose whatsoever....On the other hand, if it is a part of the compensation of such employee for services rendered to the city, or if it be for a public purpose, then clearly it is a valid exercise of the legislative power. *Id.*

The Court held that retirement plan did not violate the Constitution, despite the fact that the City of Dallas contributed to the fund out of general revenues. The Court said, "The right to participate in such fund is...not a gratuity or donation in any sense. It is as much a part of the agreed compensation as the monthly stipend." *Id.* at 741.

The continued strength of this 1928 precedent is illustrated by a recent decision of the First District Court of Appeals in Houston. *City of Houston v. Houston Firefighters' Relief & Ret.*

² All of these Sections remain in the Constitution in the same or substantially similar language as they were at the time of the 1928 opinion.

Fund, 196 S.W.3d 271 (Tex. App.–Houston [1st Dist.] 2006, no pet.). The City of Houston argued that it should not have to make contributions to the Firefighters’ retirement fund because payment of contributions for prior service credits would constitute an illegal gift of public funds. *Id.* Essentially, Houston’s argument was that the contributions had not been earned, but the court applied the broad holding of *Byrd* and determined that the contributions were a legitimate part of the firefighters’ compensation package.

These cases demonstrate that the definition of compensation is broad enough to encompass the replenishment of retirement funds lost due to third-party embezzlement. The lost retirement funds were part of the District employees’ compensation package, and the employees’ right to this compensation warrants replenishment by the District.

Government Code Chapter 609 supports this interpretation of case law, and, in turn, supports the argument for replenishment. In the Section 609.001, “Political subdivision” is defined as “a governmental entity in the state that is not a state agency and includes a county, municipality, school district, river authority, other special purpose district or authority, and junior college district [Emphasis added].”

Section 609.004 of the same Chapter says, “A deferred compensation plan governed by this chapter is a permissible use of the funds of state agency or political subdivision.” Section 609.005(a) states as, “A deferred compensation plan is part of an employee’s compensation and is in addition to a retirement, pension, or benefit system established by law [Emphasis added].” Here, the Legislature explicitly recognized employer-matched retirement funds as “compensation.” This is consistent with *Byrd*’s rationale that employer-matched funds are an integral portion of employee compensation and therefore a constitutionally permissible use of public funds.

Further, even if the District could require its employees to assume the risk of theft by an entrusted third party, a discretionary expenditure of public funds may be appropriate for the purpose of easing a private burden ancillary to a public good. In *State of Texas v. City of Austin*, 331 S.W.2d 737 (Tex.1960), the Texas Supreme Court addressed whether the Legislature could require the State to reimburse utility owners for the cost of infrastructure displaced by construction of the interstate highway system. The court, while acknowledging that these costs could be imposed upon the owners, concluded that public funds could be legitimately used to ease this burden:

“Our fundamental law does not contemplate or require that every private injury and loss which may be necessary to protect or promote the public health, safety, comfort and convenience must always be borne by individuals and corporations.”

Id. at 743

Given the salutary public purpose of the District’s deferred compensation fund, as explained above, its individual employees ought not be forced to bear the brunt of the loss. This program necessarily requires that employees relinquish custody of a portion of their compensation to entrusted individuals and institutions. To nonetheless hold those employees accountable for a

breach of that entrustment would undermine the program and thereby compromise the district's efforts to attract and retain employees.

Additionally, federal policy is premised on the assumption that governmental employers have the power and duty to insure their employee retirement programs. According to the U.S. Court of Appeals for the Fifth Circuit:

The misuse of employee retirement plans is well documented and provided the impetus for the enactment of ERISA (Employee Retirement Income Security Act). Congressional debate of this statute included numerous tales of pension plan failures and the plight of thousands of victims with nonexistent or insolvent retirement funds....Although applying ERISA to public pension plans was considered, Congress was reluctant to interfere with the administration of public retirement plans due to the resulting federalism implications. *Hightower v. Texas Hosp. Ass'n*, 65 F.3d 443, 448 (5th Cir. Tex. 1995).

After stating the public policy purpose behind the creation of ERISA, and showing that applying the plan to state and local governments had been considered, the court decided the case on a basis very pertinent to our Opinion Request. The court said:

It is this court's opinion that the result reached herein comports with the general goals of the statute and further protects the employees of the pension plan. To hold otherwise could well frustrate the goals, intent and purposes of ERISA. The statute was designed to prevent the known past abuses and possible future mismanagement of employee retirement plans. Government plans received an exemption from ERISA because of their ability to tax and thereby avoid the pitfalls of underfunding [Emphasis added]. *Id.* at 449.

As *Hightower* demonstrates, state and local governments enjoy exemption from the mandates of ERISA precisely because of the prevailing belief that such entities may rely upon public funds, when necessary, to secure their employee pensions and retirement funds. This interpretation is supported by many other opinions, and by the legislative history of ERISA. See *Rose v. Long Island R. Pension Plan*, 828 F.2d 910 (2d Cir. N.Y. 1987, cert. denied) ("The governmental plan exemption was included for several reasons....it was believed that 'the ability of the governmental entities to fulfill their obligations to employees through their taxing powers' was an adequate substitute for both minimum funding standards and plan termination insurance. S. Rep. No. 383, 93rd Cong., 2d Sess., reprinted in, 1974 U.S. Code Cong. & Ad. News 4890...."). Thus, prohibiting a governmental entity from replenishing embezzled retirement funds – i.e. prohibiting a local government from providing its employees similar protection as those under ERISA – invites encroachment into state and local government retirement plan regulation.

Conclusion:

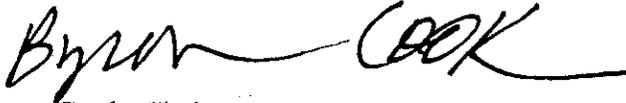
The District has authority to establish an employer-matching retirement program based on the Texas Constitution, the District's enabling legislation, the Texas Government Code, and case law. Because the employee-matched retirement funds are compensation under Texas law, the

loss of such funds due to embezzlement deprives District employees of earned compensation. Adequate compensation, and, in turn, adequate staffing, is necessary to the District's public function of meeting community health care needs, including the needs of those that cannot afford to pay. Prohibiting the District from replenishing the retirement funds not only hampers the District's ability to carry out its public function, but also creates the risk that the federal government will encroach on state and local retirement plans if it is determined that local governments cannot protect employees against the risk of retirement fund embezzlement.

Request:

May Gonzales Healthcare Systems, a hospital district established pursuant to Article IX, Section 9, of the Texas Constitution, replenish employee retirement funds lost due to embezzlement by a third party administrator and accept assignment of such employees' claims against the third party administrator?

Best Regards,

A handwritten signature in black ink that reads "Byron Cook". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Byron Cook, Chairman
House Civil Practices Committee
State Representative
District 8

BC/cll