

**State of Minnesota
Office of the State Auditor**



**Patricia Anderson
State Auditor**

**MINNEAPOLIS TEACHERS' RETIREMENT FUND
ASSOCIATION
SPECIAL REVIEW REPORT**

October 3, 2006

Description of the Office of the State Auditor

The Office of the State Auditor serves as a watchdog for Minnesota taxpayers by helping to ensure financial integrity, accountability, and cost effectiveness in local governments throughout the state.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 250 financial and compliance audits per year and has oversight responsibilities for over 4,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice – conducts financial and legal compliance audits for local governments;

Government Information – collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations – provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government;

Pension Oversight – monitors investment, financial, and actuarial reporting for over 700 public pension funds;

Tax Increment Financing (TIF) – promotes compliance and accountability in local governments' use of TIF through financial and compliance audits.

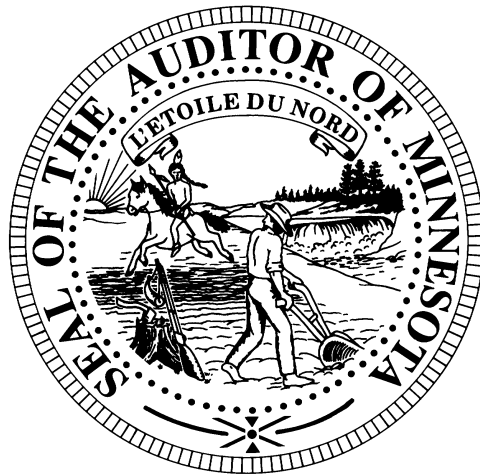
The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employee's Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

Office of the State Auditor
525 Park Street, Suite 500
Saint Paul, Minnesota 55103
(651) 296-2551
state.auditor@state.mn.us
www.auditor.state.mn.us

This document can be made available in alternative formats upon request. Call (651) 296-2551 [voice] or 1-800-627-3529 [relay service] for assistance; or visit the State Auditor's website: www.auditor.state.mn.us.

**MINNEAPOLIS TEACHERS' RETIREMENT FUND
ASSOCIATION
SPECIAL REVIEW REPORT**

OCTOBER 3, 2006



**Office of the State Auditor
State of Minnesota**

**MINNEAPOLIS TEACHERS' RETIREMENT FUND ASSOCIATION
SPECIAL REVIEW REPORT**

TABLE OF CONTENTS

	<u>Page</u>
1. EXECUTIVE SUMMARY	i
2. REPORT	
I. Special Review	1
II. Minneapolis Teachers' Retirement Fund Association	2
III. 2006 Consolidation Legislation	6
IV. Creation of the Liquidating Trust	8
V. Liquidating Trust Legal Issues	12
VI. Administrative Expenses Paid by MTRFA But Also Included in Liquidating Trust Funding	17
VII. Lack of Necessity for, and Coercive Conditions of, the Liquidating Trust	21
VIII. Transfer of Other Assets and Records	25
IX. MFTRA Contract Created After Enactment of Consolidation Legislation in Violation of Law	34
X. Open Meeting Law	36
XI. Administrative Expenses	39
XII. Transfer of Invested Assets and Fixed Assets and Equipment	43
XIII. Conclusion	44
3. APPENDIX	
1. Chronology	App. 1
2. Expenses and Liquidating Trust	App. 23
3. MTRFA Total Administrative Expenses	App. 25
4. TRA RESPONSE	

This page was left blank intentionally.

Executive Summary



PATRICIA ANDERSON
STATE AUDITOR

STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

MINNEAPOLIS TEACHERS' RETIREMENT FUND ASSOCIATION SPECIAL REVIEW REPORT

October 3, 2006

EXECUTIVE SUMMARY

Report Summary:

Pursuant to a request from the Minnesota Teachers Retirement Association (TRA), the State Auditor's Office performed a special review of the overall legal compliance and administrative expenses of the Minneapolis Teachers' Retirement Fund Association (MTRFA).

The MTRFA was a major Minnesota public pension plan that provided pension benefits to teachers of the Minneapolis School District. The MTRFA's deteriorating financial condition became so severe that the Minnesota Legislature in 2006 consolidated it with the TRA. The consolidation legislation mandated that the MTRFA transfer its assets to the TRA by June 30, 2006. The MTRFA would also cease to exist on that date. All members of the MTRFA were transferred to the TRA on July 1, 2006.

The MTRFA Board and Executive Director were public pension plan fiduciaries under state law. As fiduciaries, the MTRFA Board members and Executive Director owed a fiduciary duty to the MTRFA pension plan beneficiaries, as well as to taxpayers, and to the State of Minnesota. Their duty was to act in accordance with the law and in good faith on behalf of the beneficiaries, the taxpayers, and the State.

The State Auditor's Office found instances of noncompliance with Minnesota law, the most egregious of which was the diversion of over \$1.5 million to a "Liquidating Trust" primarily for the benefit of the MTRFA Board and Executive Director. Except for money diverted to the Liquidating Trust and the information on a laptop computer hard drive, substantially all of the assets of the MTRFA have been transferred to the TRA.

Major Findings:

Liquidating Trust

Since at least June of 2005, the MTRFA Board was making plans to hold back pension funds from the state whenever consolidation with the TRA occurred. In June 2005, the MTRFA passed a formal resolution to create an account into which funds were to be transferred for the purpose of paying the MTRFA “legal obligations.” According to the resolution, this account would not be transferred to the State as part of consolidation. These actions were part of the MTRFA plans to continue after consolidation. Correspondence from the MTRFA’s attorney to its Executive Director in November of 2005 suggests workshop topics concerning the MTRFA’s new mission and purpose after consolidation with the TRA.

The 2006 Consolidation Legislation frustrated the MTRFA’s plans for continued existence. It mandated the transfer of the MTRFA assets to the TRA on June 30, 2006, and also specifically stated that the MTRFA would cease to exist on that date. The MTRFA responded to this Consolidation Legislation by diverting over \$1.5 million from the MTRFA Special Retirement Fund into a “Liquidating Trust.” The Liquidating Trust was primarily for the benefit of the MTRFA Board members and Executive Director, and not for the retired Minneapolis teachers’ benefit. This money has not been transferred to the TRA.

The withholding of this money from the TRA and many of the provisions of the Liquidating Trust Agreement violate the Consolidation Legislation and other Minnesota laws. Specifically, there was no legal authority for the diversion of money from the special retirement fund, the exclusive benefit law for pension funds was violated, and the diversion of funds was a prohibited transaction under Minnesota’s fiduciary laws.

Contrary to the stated justification for creating the illegal Liquidating Trust, the State Auditor’s Office found that almost all of the bills and obligations identified to justify the over \$1.5 million amount diverted to the illegally created Liquidating Trust were, in fact, paid by the MTRFA before the consolidation became effective. The money should be released to the TRA for the benefit of retired teachers.

The text of the Liquidating Trust Agreement and the manner in which it was created demonstrate an intent to usurp the consolidation process designed and enacted by the Legislature. In addition to refusing to transfer all of its money over to the TRA, the MTRFA sought to create a substitute system of bill processing and indemnification contrary to the explicit terms of the Consolidation Legislation.

Provisions of the Liquidating Trust attempt to coerce release of claims and bad faith indemnification from the State of Minnesota. The threat is that the Liquidating Trust will continue to withhold the money from the TRA unless the State of Minnesota meets the coercive demands built into the Trust that primarily are for the benefit of the MTRFA Board and Executive Director. The Liquidating Trust is in effect holding the \$1.5 million hostage until the former MTRFA’s ransom demands are met.

Missing Assets and Records

After being told she could not purchase the MTRFA laptop computer assigned to her, the MTRFA Executive Director removed the hard drive from the laptop computer. The laptop computer provided to the TRA pursuant to the Consolidation Legislation had no hard drive. After TRA's demand, the Executive Director later turned over a hard drive that had been actively wiped clean to a point where data was totally unrecoverable. None of the information on the MTRFA hard drive was turned over to the TRA as required by the Consolidation Legislation. Other records required to be transferred to the TRA on June 30, 2006, which were withheld included a compact disk containing private data, tapes of Board meetings, attorney bills, and emails.

New Contractual Liability Incurred

The Consolidation Legislation clearly mandated that the MTRFA was required to obtain the TRA's approval before incurring any new or additional contractual liability or obligation between the day after final enactment, May 27, 2006, and June 30, 2006. However, the State Auditor's Office discovered that the MTRFA incurred an \$118,996 liability on June 14, 2006, when a six-year extension of its fiduciary liability coverage, known as "tail coverage" was ordered. The MTRFA then paid the \$118,996 bill before the consolidation. By incurring this liability after May 27, 2006, without the TRA's approval, the MTRFA violated the Consolidation Legislation.

Conclusion

It is the conclusion of the State Auditor's Office that the MTRFA Board of Trustees and Executive Director violated the fiduciary standards of conduct in various ways, but especially in creating and funding the Liquidating Trust. We find that the Liquidating Trust was created to intentionally withhold money from the TRA after consolidation. The Liquidating Trust was created for the benefit of the MTRFA Board and Executive Director, and not for the benefit of retired Minneapolis teachers.

Because this Special Review Report discloses malfeasance, misfeasance, or nonfeasance, it will be filed with the Hennepin County Attorney for the institution of such civil and criminal proceedings as the law and the protection of the public interests shall require.

This page was left blank intentionally.

Report



PATRICIA ANDERSON
STATE AUDITOR

STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
Hstate.auditor@state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

MINNEAPOLIS TEACHERS' RETIREMENT FUND ASSOCIATION SPECIAL REVIEW REPORT

October 3, 2006

I. SPECIAL REVIEW

On July 19, 2006, the Minnesota Teachers Retirement Association (TRA) asked the State Auditor's Office to perform a special review of the Minneapolis Teachers' Retirement Fund Association (MTRFA). The letter of request stated:

Recently enacted legislation, Minnesota Session Laws [2006] Chapter 277, Article 3 has resulted in the consolidation of the Minneapolis Teachers Retirement Fund Association (MTRFA) with the Minnesota Teachers Retirement Association (TRA), effective June 30, 2006.¹

The TRA asked the State Auditor's Office to perform a special review of the MTRFA's overall legal compliance with chapter 277 and other applicable Minnesota statutes such as Minnesota statutes, chapters 13 (Minnesota Government Data Practices Act), 354 (Teachers Retirement Act), 354A (Teachers Retirement, Certain Cities), 356 (Retirement Systems, Generally), and 356A (Public Pension Fiduciary Responsibility). The request identified the following "[p]articular areas of interest:"

- Analysis of administrative expenses over the past year, in particular, expenditures relating to the Liquidating Trust and consolidation.
- Evaluation of compliance with Minn. Stat. § 354.70, subd.7 prohibiting the MTRFA from incurring any new or additional enforceable contractual liabilities without approval of the TRA.
- Evaluation of compliance with the Consolidation Legislation requirement that the entire assets, including fixed assets and equipment, of the MTRFA be transferred to the TRA.²

¹ July 19, 2006 letter from TRA Executive Director Hacking to State Auditor Anderson.

² *Id.*

Because the public interest demands a thorough review of the MTRFA's administration, expenses, investments and financial condition at the time of consolidation, the State Auditor's Office performed the requested special review.

We obtained and relied on information for our special review from, but not limited to, the following sources:

- Voluntary interviews with former MTRFA staff, the Executive Director, and the Board of Trustees;
- Discussions, correspondence, and documents involving attorneys and financial advisors associated with the former MTRFA and the Liquidating Trust;
- Documents and records of the former MTRFA for, approximately, the period of July 1, 2005, through June 30, 2006, such as:
 - Minutes and notes related to the board and committee meetings;
 - Contracts, agreements, and policies;
 - General ledger, spreadsheets, cancelled checks, invoices, reimbursement requests, and custodian reports;
- Communication with representatives from the TRA and the State Board of Investment (SBI);
- Documents and correspondence of the TRA and the SBI;
- Minnesota laws and statutes;
- Legislative hearing audio archives; and
- Documents, communications, and correspondence of the State Auditor's Office.

II. MINNEAPOLIS TEACHERS' RETIREMENT FUND ASSOCIATION

Like other teachers' retirement fund associations in cities of the first class, the MTRFA was originally created under 1909 Minn. Laws, ch. 343. This law authorized the teachers in these cities to establish a teachers' retirement fund association with the consent of the city council. These teachers' retirement fund associations had the powers and privileges provided in the 1909 law.³ The law required the plan for establishing such an association to include the organization of a corporation under the then-existing statutory chapter on corporations.⁴ The 1909 law provided that in order to "avail itself of the privileges of this act," a city's teaching body had to:

formulate a plan for the formation and incorporation of such an association and the collection and disbursement of a fund for the benefit of retired teachers in said city, which . . . shall be submitted to the . . . city council of said city for approval."⁵

³ 1909 Minn. Laws, ch. 343, § 1.

⁴ 1909 Minn. Laws, ch. 343, § 2. Rev. Laws of Minnesota, 1905, ch. 58 authorizes several types of corporations. A corporation formed solely for public and governmental purposes was deemed a "public corporation," while others were considered "private corporations." Rev. Laws of Minnesota, 1905, § 2839.

⁵ 1909 Minn. Laws, ch. 343, § 3.

It provided that city council approval was needed before a teachers' retirement fund association could receive and disburse funds according to the plan.

The modern statute under which the MTRFA existed prior to its consolidation with the TRA recognized that the teachers' retirement fund association in each city of the first class "shall be a continuation of the teachers retirement fund association" with the same name established pursuant to the 1909 law.⁶ Like the other teachers' retirement fund associations in cities of the first class, the MTRFA was "organized and governed" pursuant to Minn. Stat. ch. 354A and ch. 317A.⁷

The MTRFA was not, however, a nonprofit corporation with general powers. It existed for the purpose of operating a plan to provide benefits to its members. The MTRFA was a teachers' retirement fund association and a public pension plan under Minnesota statutes.⁸ All of the legal limitations applicable to public pension plans and teachers' retirement fund associations also applied fully to the MTRFA. In this regard, the Minnesota Nonprofit Corporation Act clearly states "[a] corporation engaging in conduct that is regulated by another statute is subject to the limitations of the other statute."⁹ Public pension plans are subject to many legal limitations that are described in more detail below.

Generally, a corporation can be incorporated under the Minnesota Nonprofit Corporation Act for any lawful purpose "unless another statute requires incorporation for a purpose under a different law."¹⁰ The Nonprofit Corporation Act recognizes that "applicable federal or state law" and its articles of incorporation limit a nonprofit corporation's powers.¹¹ A review of the MTRFA Articles of Incorporation and the laws applicable to the MTRFA and other public pension plans in Minnesota demonstrate that the MTRFA had the powers and limitations of a public pension plan and did not exist for general purposes.

Several provisions of the MTRFA's Restated Articles of Incorporation specifically acknowledged that the MTRFA was governed by Minnesota's pension plan laws and that its purpose was solely limited to providing for a fund to pay benefits to MTRFA members. The Restated Articles of Incorporation began with a preamble that clearly stated the MTRFA was governed by Minnesota statutes that controlled teachers' retirement in certain cities, nonprofit corporations, and retirement systems generally.¹²

⁶ Minn. Stat. § 354A.021, subd. 1 (2004).

⁷ Minn. Stat. § 354A.021, subd. 2 (2004).

⁸ Minn. Stat. §§ 354A.021, subd. 2; 356.20, subd. 2 (5) (2004).

⁹ Minn. Stat. § 317A.101 (2004).

¹⁰ *Id.*

¹¹ Minn. Stat. § 317A.161, subd. 1 (2004) ("A corporation has the powers in this section, subject to limitations provided in applicable federal or state law or in its articles or bylaws."); Minn. Stat. § 317A.101 (2004) (A corporation has a general purpose of engaging in any lawful activity only if its purpose is not limited in its articles.).

¹² MTRFA Restated Articles of Incorporation, Preamble.

Similarly, the Articles limited the MTRFA's purpose to providing for benefits to members.¹³

The MTRFA was tax exempt as a local teachers' retirement fund association.¹⁴ The MTRFA was a public pension plan with a limited purpose. As provided in the 1909 law and Minn. Stat. ch. 354A, its incorporation was required for the purpose of operating a teachers' retirement fund association. The MTRFA was not a nonprofit corporation with general tax-exempt purposes.¹⁵

The MTRFA's membership consisted of eligible employees of the Minneapolis Special School District No. 1, employees formerly employed by the School District, and employees of the MTRFA. A seven-member Board of Trustees governed the MTRFA.

The MTRFA also had an appointed Executive Director with extensive powers. Pursuant to Article 8.10 of its Articles of Incorporation, the MTRFA Board appointed an Executive Director to act as chief executive, chief financial and principal investment management officer of the MTRFA.¹⁶ The Executive Director organized and managed the office, hired and supervised employees, and entered into contracts for goods and services including legal, actuarial and investment services. The Executive Director was empowered to buy and sell assets to achieve the investment objectives of the Board. Further, the Executive Director had the responsibility to "[p]repare and recommend to the Board of Trustees appropriate rules" to carry out the provisions of its Articles and Minnesota law.

Like other teachers' retirement fund associations, the MTRFA was required by law to include "all of the assets" of the association in its special retirement fund, with the exception of the assets of an authorized tax sheltered annuity program and fund.¹⁷ The law stresses that "[t]he special retirement fund shall be credited with all employee and employer contributions, all interest and all other income authorized by law."¹⁸ Under Minnesota law, the assets of the special retirement fund must be disbursed only for the

¹³ MTRFA Restated Articles of Incorporation, Article 3 – Purpose.

¹⁴ 26 U.S.C. § 501 (c) (11). A teachers' retirement fund association of a purely local character can be exempt from taxation if no part of its net earnings inures to the benefit of any private shareholder or individual, and "the income consists solely of amounts received from public taxation, amount received from assessments on the teaching salaries of members, and income in respect of investments." *Id.* In 1986, MTRFA applied with the Internal Revenue Service for a determination that it was a qualified defined benefit plan. The application was granted. In its application, citing Minn. Stat. § 354A.021, subd. 6, MTRFA stated that "[f]or fiduciary purposes, [MTRFA] is deemed to be a trust fund." MTRFA Attachment to Form 5300, Item 6. Because it claimed status as "a government plan", MTRFA sought and received exemptions from various rules and regulations. *See, e.g.*, MTRFA Attachment to Form 5300, Items 12 and 15.

¹⁵ This is important because the MTRFA representatives at times seemed to think the MTRFA was both a teachers' retirement fund association *and* in addition, a nonprofit corporation created for general purposes. *See* June 14, 2005 Butterbrodt letter to Kilberg; June 15, 2005 MTRFA Board of Trustees Resolution, described in the Chronological Appendix.

¹⁶ MTRFA Restated Articles of Incorporation and Minnesota Statutes Chapter 354A (January 1994).

¹⁷ Minn. Stat. § 354A.021, subd. 3 (2004).

¹⁸ *Id.*

purposes provided for in Minnesota statutes, chapter 354A, or in the articles of incorporation.¹⁹ “All *appropriate expenses of and any authorized benefits* provided by the teachers retirement fund association shall be paid from the special retirement fund.”²⁰

The MTRFA’s Articles of Incorporation also provided that all of the MTRFA assets must be in the MTRFA Special Retirement Fund. They stated “[t]here is hereby established a special retirement fund which shall include all of the assets of the Association.”²¹ The Articles provided that the “Executive Director shall be the custodian of the assets of the special retirement fund,” and that “[t]he Executive Director shall receive and account for all assets of the Association and pay the same out only in accordance with the provisions of the Articles and Bylaws of the Association and applicable Minnesota Statutes.”²²

Assets of a covered pension plan may be held only by the plan treasurer, the State Board of Investment, or their depository agents.²³ In addition, legal title to plan assets must be vested in the plan, the State Board of Investment, the governmental entity that sponsors the plan, the nominee of the plan, or the depository agent.²⁴

Under the provisions of the Minnesota Public Pension Fiduciary Responsibility Act, the “fiduciaries” of the MTRFA included the board of trustees and the Executive Director.²⁵ They were required to act in good faith toward the beneficiaries of the pension plan.²⁶ Minnesota courts have held that a trustee is bound to exercise the utmost good faith towards the beneficiaries.²⁷ In addition to good faith, a fiduciary must act solely in the interest of the beneficiaries.²⁸ Under Minnesota law, the MTRFA Board and Executive Director owed a fiduciary duty to the active and retired members of the MTRFA, the taxpayers, and the State of Minnesota.²⁹ The MTRFA fiduciaries owed all three of these parties the utmost good faith in their dealings and had the obligation to act solely on these parties’ behalf.

With regard to the duties of fiduciaries generally, it has been held that the fundamental duty owed by trustees to beneficiaries is the duty of loyalty.³⁰ The duty of good faith and the duty of loyalty preclude a fiduciary from engaging in activities that involve self-dealing.³¹ “Actions are done in good faith when done honestly, whether it be negligently

¹⁹ Minn. Stat. § 354A.021, subd. 4 (2004).

²⁰ *Id.* *Emphasis added.*

²¹ MTRFA Restated Articles of Incorporation, § 10.1. The Articles track Minnesota law by including an exception for any tax sheltered annuity program and fund, if any. *See* Minn. Stat. § 354A.021, subd. 3 (2004).

²² MTRFA Restated Articles of Incorporation, § 10.5.

²³ Minn. Stat. § 356A.06, subd. 1 (2004).

²⁴ *Id.*

²⁵ Minn. Stat. § 356A.02, subd. 1 (2004).

²⁶ Minn. Stat. § 356A.04, subd. 2 (2004).

²⁷ *Schug v. Michael*, 310 Minn. 22, 245 N.W.2d 587 (1976).

²⁸ Restatement (Second) of Trusts § 170 (1959).

²⁹ Minn. Stat. § 356A.04, subd. 1 (2004).

³⁰ 3 Scott, Trusts § 170 at 311 (4th Ed. 1988).

³¹ *Magruder v. Drury*, 235 U.S. 106 (1914).

or not.”³² “On the other hand, actions are done in bad faith when a party’s refusal to fulfill some duty or contractual obligation is based on an ulterior motive, not an honest mistake regarding one’s rights or duties.”³³

Additionally, Minnesota public pension plan fiduciaries are required to act in a manner consistent with state law.³⁴

In summary, the fiduciaries of the MTRFA had an affirmative duty to the members and beneficiaries of the plan, to the taxpayers, and to the State of Minnesota, to act in utmost good faith in accordance with state law, and not in “bad faith” in order to advance their own self-interests.

III. 2006 CONSOLIDATION LEGISLATION

Throughout its history, the MTRFA has experienced funding difficulties. Its funding problems accelerated, however, in recent years. According to the MTRFA’s actuarial valuation and review for June 30, 2005, the unfunded actuarial accrued liability was \$972.6 million, reflecting an 88 percent increase since June 30, 2000. During this period, the funded ratio fell from 66.54 percent to 44.61 percent.³⁵

With close to \$1 billion in unfunded actuarial accrued liabilities, and the need to systematically sell permanent investments to fund monthly annuity payments, most actuarial and public pension experts believed that the MTRFA was at significant risk of default.³⁶

The legislation that consolidated the MTRFA with the TRA was several years in the making. Various consolidation proposals were considered and advanced in recent years, and the MTRFA’s plight was a frequent discussion topic for the Legislative Commission on Pensions and Retirement in 2006 and past legislative sessions.³⁷

In order to address the MTRFA’s deteriorating financial condition, Consolidation Legislation to consolidate the MTRFA with the statewide TRA was passed by the Minnesota Legislature on May 20, 2006.³⁸ Governor Pawlenty “enacted” the legislation by signing the bill on May 26, 2006.³⁹ The Consolidation Legislation designed by the Legislature carefully and thoroughly provided for the consolidation of the MTRFA into the TRA. It provided for the transfer of members, responsibilities, assets, records, and

³² *Prairie Island Indian Community v. Minnesota Dept. of Public Safety*, 658 N.W.2d 876,899 (Minn. App. 2003).

³³ *Id.*

³⁴ Minn. Stat. § 356A.05 (b) (2004).

³⁵ MTRFA Audit Report for the Year Ended June 30, 2005 (Office of the State Auditor) p. 33. *See* Chronology Appendix.

³⁶ *See, e.g.*, March 9, 2004 Memorandum from Legislative Commission on Pensions and Retirement’s Executive Director, p. 7.

³⁷ *See* Chronology Appendix.

³⁸ *See* 2006 Minn. Laws ch. 277.

³⁹ *See* Minn. Stat. § 645.01, subd. 2 (2004).

liabilities and obligations. The consolidation will ensure that retired Minneapolis teachers will receive their pensions.

Important provisions of the Consolidation Legislation include the following:

- The Consolidation Legislation expressly provided that the MTRFA ceased to exist as of June 30, 2006.⁴⁰ The law repealed the MTRFA Articles of Incorporation and Bylaws.⁴¹ All *records and documents* relating to the funds and benefit plans had to be transferred to the TRA by June 30, 2006.⁴²
- The MTRFA was required to obtain the TRA's approval before incurring any new or additional contractual liability or obligation between the day after final enactment, May 27, 2006, and June 30, 2006.⁴³
- On or before June 30, 2006, the MTRFA was required by law to transfer to the TRA *the entire assets* of the MTRFA Special Retirement Fund.⁴⁴ Effective June 30, 2006, MTRFA employees had their employment with the MTRFA terminated.
- As of June 30, 2006, *assets of the special retirement fund* of the MTRFA became assets of the TRA to be invested by the SBI under § 354.07, subd. 4.⁴⁵
- As of July 1, 2006, all members of the MTRFA became members of the TRA.⁴⁶ In addition, effective July 1, 2006, the former MTRFA employees, other than the Executive Director, became employees of the TRA until December 31, 2007.⁴⁷

Many pension plans have been consolidated by the Legislature.⁴⁸ In this case, the Legislature applied to this consolidation the statute it had established for the orderly and thorough consolidation of state agencies. Provisions of that statute, Minn. Stat. § 15.039, subds. 5 and 5a (Effect of transfer of powers among agencies), are specifically cited in the Consolidation Legislation. These provisions state:

Subd. 5. **Contracts; records.** The agency whose responsibilities are transferred shall give all contracts, books, maps, plans, papers, records, and property of every description relating to the transferred responsibilities and within its jurisdiction or control to the new agency. The new agency shall accept the material presented. The transfer shall be made in accordance with the directions of the new agency.

⁴⁰ 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 7 (a).

⁴¹ *Id.*

⁴² 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 4. *Emphasis added.*

⁴³ 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 7 (b).

⁴⁴ 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 5. *Emphasis added.*

⁴⁵ *Id.* *Emphasis added.*

⁴⁶ See 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 1.

⁴⁷ See 2006 Minn. Laws, ch. 277, art. 3, § 43.

⁴⁸ See January 13, 2006 Memorandum from Legislative Commission on Pensions and Retirement Executive Director, p. 5.

Subd. 5a. **Obligations.** The new agency is the legal successor in all respects of the agency whose responsibilities are transferred. The bonds, resolutions, contracts, and liabilities of the agency whose responsibilities are transferred become the bonds, resolutions, contracts, and liabilities of the new agency.⁴⁹

The TRA effectively “stepped into the shoes” of the MTRFA with respect to its bills and other obligations. The Consolidation Legislation accomplished this by making the TRA “the successor in interest” to all claims against the former MTRFA except for fiduciary duty claims “where the act or acts constituting the claimed breach was not done in good faith.”⁵⁰

Finally, the TRA is required to provide indemnification to the former MTRFA fiduciaries consistent with indemnification available to other pension plan fiduciaries under the Public Pension Fiduciary Responsibility Act, Minn. Stat. § 356A.11.⁵¹ Minn. Stat. § 356A.11, in turn, specifically provides indemnification “from liability for fiduciary breach” to “[a] fiduciary who is a member of the governing board of a pension plan . . . or who is an employee of a covered pension plan.”⁵²

IV. CREATION OF THE LIQUIDATING TRUST

In May 2006, unbeknownst to the TRA, the Legislative Commission on Pensions and Retirement, and the Senate and House committees involved in the consideration of the Consolidation Legislation; the MTRFA held a special meeting at which it approved placing MTRFA Special Retirement Fund money into the MTRFA Liquidating Trust (Liquidating Trust), the purpose of which was to withhold pension plan money from consolidation.⁵³

Even though all of the MTRFA’s money was required to be in its special retirement fund, this was not the first time the MTRFA considered withholding money from legislatively mandated consolidation. As far back as May 18, 2005, after a closed “executive session” to discuss “administrative items,” the MTRFA Board voted to set aside an “escrow

⁴⁹ Minn. Stat. § 15.039, subds. 5, 5a (2004).

⁵⁰ *Id.* Other qualifications state (1) the TRA may assert any applicable defense to any claim that the former MTRFA would have been entitled to assert, (2) the TRA may assert any applicable defense that the TRA may assert in its capacity as a statewide agency, and (3) the TRA shall indemnify the MTRFA’s former fiduciaries consistent with the provisions of the Public Pension Fiduciary Responsibility Act.

⁵¹ 2006 Minn. Laws, ch. 277, art 3, § 9, subd. 5 (b) (4).

⁵² The MTRFA is a “pension plan” and a “covered pension plan” under the applicable definitions. First, Minn. Stat. § 356A.01, subd. 20, defines “pension plan” to mean “all aspects of an arrangement between a public employer and its employees concerning the pension benefit coverage provided to the employees.” Second, Minn. Stat. § 356A.01, subd. 8, defines “covered pension plan” to mean “a pension plan or fund listed in section 356.20, subdivision 2” The MTRFA is listed in Minn. Stat. § 356.20, subd. 2, as a covered pension plan.

⁵³ See MTRFA Board of Trustees Special Meeting minutes – May 8, 2006; Liquidating Trust Agreement, p. 4.

account” to cover expenses and obligations.⁵⁴ The “escrow account” idea was replaced, after another closed meeting to discuss “legal and employee” issues on June 15, 2005, by a resolution asserting the MTRFA was going to survive consolidation as a non-profit corporation with general tax-exempt purposes. This resolution purported to establish “a separate, related expense operating account” that “shall not be subject to transfer to the State of Minnesota with other assets to be transferred as part of [the] Consolidation.”⁵⁵

The effort to exist as a separate nonprofit entity after consolidation continued in the fall of 2005. A letter from the MTRFA attorney to the MTRFA Executive Director included a list of possible workshop topics on “the role of the MTRFA after the retirement fund is rolled into TRA.”⁵⁶ The topics included whether the MTRFA would continue to have a mission “after the Fund itself is transferred to the state,” whether that mission might be advocacy, membership service or health care benefits, and how the MTRFA could continue to qualify for tax exempt status.⁵⁷

On March 6, 2006, after the TRA had difficulty getting information on MTRFA contract liabilities and obligations it would assume under consolidation, the State Auditor’s Office wrote the MTRFA Executive Director formally requesting “copies of all MTRFA contracts currently in existence, that create liability or obligation on the part of MTRFA.”⁵⁸ Copies of the contracts were due to the State Auditor’s Office by March 16, 2006.⁵⁹ The day before the due date, the MTRFA Board met. After a closed meeting “to discuss personnel issues,” the MTRFA Board approved measures including an amendment and extension of the MTRFA Executive Director’s employment contract to June 30, 2007.⁶⁰ On the same day, March 15, 2006, the MTRFA attorney wrote to the MTRFA Executive Director. In this letter, the attorney stated:

We have discussed the idea of a reserve account to hold funds for paying the contractual obligations of the MTRFA that are related to its staff employees and to hold such an account back from transfer to the state in the anticipated consolidation. The motivation for holding such an account back would be to guarantee payment of the contractual obligations to staff and thereby avoid the risk that such obligations would not be honored by the state.⁶¹

⁵⁴ May 18, 2005 MTRFA Board of Trustees Meeting Minutes. No money was transferred to an escrow account by the MTRFA in fiscal year 2005. As a result, the State Auditor’s Office did not review this issue as part of its 2005 financial audit of the MTRFA.

⁵⁵ June 15, 2005 MTRFA Board of Trustees Meeting Minutes. Again, no money was placed in a separate account of this description. A letter from the MTRFA attorney describes the account as a “subfund” that “would not be transferred to the State of Minnesota with the assets of the Special Retirement Fund as part of the funding consolidation.” June 14, 2005 Butterbrodt letter to Kilberg.

⁵⁶ November 10, 2005 Butterbrodt letter to Kilberg.

⁵⁷ *Id.*

⁵⁸ March 6, 2006 Kenney letter to Kilberg.

⁵⁹ *Id.*

⁶⁰ March 15, 2006 MTRFA Board of Trustees Meeting Minutes.

⁶¹ March 15, 2006 Butterbrodt letter to Kilberg.

It is against this background that the Liquidating Trust was created to withhold funds from consolidation. An additional closed “executive session” was held with the MTRFA attorneys Butterbrodt and Lazarus on April 19, 2006 to discuss merger and staffing issues, evidently including the Liquidating Trust.⁶² Then, on May 8, 2006, the MTRFA Board approved the creation of the Liquidating Trust at a special meeting. The Liquidating Trust Agreement was signed by the Liquidating Trustee, Harry J. Haynsworth, and became effective on May 22, 2006, the same day the Consolidation Legislation was presented to the Governor and two days after the Consolidation Legislation passed the Minnesota House of Representatives and Senate.

In the Liquidating Trust Agreement, the MTRFA was identified as the “grantor” of the Liquidating Trust. The money for the Liquidating Trust was taken from the MTRFA Special Retirement Fund.

The beneficiaries of the Liquidating Trust are the MTRFA fiduciaries, “namely, Norm Moen, Lydia Lee, Larry Risser, Ann Downing, Kilee Christangel (sic), Birdie Carter, Rod Martel, all the foregoing being members of the Board of Trustees. . . and Karen Kilberg, the Executive Director. . .” The Liquidating Trust Agreement calls these individuals the “Initial Beneficiaries.” Creditors are “Secondary Beneficiaries,” while the TRA is listed as the “Tertiary Beneficiary.”⁶³

Liquidating Trustee Haynsworth was granted the “sole and absolute discretion” to decide whether claims and obligations should be paid.⁶⁴ He also was granted complete discretion to determine if any of the MTRFA fiduciaries (the MTRFA’s Board and Executive Director) would be indemnified for claims that may be made against them.⁶⁵

The Liquidating Trust Agreement listed the following potential liabilities and obligations that, according to the Liquidating Trust Agreement, the MTRFA may not have had the ability or sufficient funds to pay:

- Contracts and expenses to conduct a membership election to authorize the MTRFA’s transfer of assets to the TRA;
 - Indemnification of the fiduciaries for past, present, and future obligations;
 - Premiums for fiduciary liability “tail coverage”;
 - Any contracts, debts, obligations or liabilities to third parties;
 - General and administrative operating expenses and costs of the Liquidating Trust;
 - Severance obligations to employees;
 - Amounts due the Executive Director under her employment contract;
 - Liquidating trustee fees and costs;
 - Professional fees and costs incurred prior to, and subsequent to, consolidation;
- and

⁶² Barry Lazarus of Moss & Bennett and Robert Butterbrodt represented the MTRFA.

⁶³ Liquidating Trust Agreement, pp. 4-5.

⁶⁴ Liquidating Trust Agreement, Section 7(d), p. 9.

⁶⁵ *Id.*

- A reasonable additional amount for unanticipated fees, costs, and expenses.⁶⁶

In a letter dated May 26, 2006, a financial advisor hired by the MTRFA Board estimated that \$1,532,178 was needed in the Liquidating Trust to meet the potential liabilities and obligations itemized in the Liquidating Trust Agreement. On the same day, the MTRFA transferred \$1,532,178 from the assets of the MTRFA's Special Retirement Fund to the Liquidating Trust.

According to the Liquidating Trust Agreement, the Liquidating Trust does not terminate until all applicable statutes of limitations have run; **or** the State of Minnesota has provided a full and final release in a form satisfactory to the Liquidating Trustee's legal counsel that fully and finally releases the MTRFA fiduciaries (MTRFA's Board and Executive Director) from all claims by the State, including claims based on the Liquidating Trustee's performance of duties, and indemnifies, holds harmless, and defends the MTRFA fiduciaries from any and all claims, **and** the State has provided a written assumption of the MTRFA obligations.⁶⁷

The TRA and the State Auditor's Office first learned about the Liquidating Trust on June 1, 2006, when the Liquidating Trustee Harry Haynsworth and his attorney, Thomas Heffelfinger, visited the TRA and the State Auditor's Office, as well as the Governor's Office and the Attorney General's Office, and informed them about the Liquidating Trust.⁶⁸ The TRA demanded that the Trust return all the special retirement assets to the MTRFA for prompt transfer to the TRA. The Liquidating Trustee refused to do so.

The MTRFA, the MTRFA Board, the MTRFA's Executive Director, the Liquidating Trust, and Mr. Haynsworth as Liquidating Trustee sued the Minnesota Attorney General and the TRA on June 19, 2006, in Hennepin County District Court, seeking a declaratory judgment that 1) the Liquidating Trust was lawfully established; 2) the Board and Executive Director acted lawfully by taking actions under the Minnesota Nonprofit Corporation Act; and 3) the TRA must indemnify the Board and Executive Director under Minn. Stat. § 317A.521.

In response, the TRA filed counterclaims, arguing the Liquidating Trust was illegal. The TRA sought an order that, among other things, would require that all assets held by the Liquidating Trust be turned over to the TRA pursuant to the Consolidation Legislation.⁶⁹ On June 26, 2006, the District Court denied the TRA's request for a temporary restraining order.

⁶⁶ Liquidating Trust Agreement, pp. 2-3.

⁶⁷ Liquidating Trust Agreement, pp. 6-7.

⁶⁸ They did not bring a copy of the Liquidating Trust Agreement to the meeting with the State Auditor's Office. The State Auditor's Office obtained a copy from TRA.

⁶⁹ The State Auditor's Office is not a party to the lawsuit or counterclaims. The litigation is pending as of the date of this report.

V. LIQUIDATING TRUST LEGAL ISSUES

The State Auditor's Office was asked to review the MTRFA's compliance with Minnesota statutes, chapters 354, 354A, 356 and 356A. These statutes govern how public pension funds are administered in Minnesota.

The creation of the Liquidating Trust, the transfer of over \$1.5 million in public pension funds from the MTRFA Special Retirement Fund to the Liquidating Trust, and the continued retention of these funds in the Liquidating Trust exceed the MTRFA's authority and violate Minnesota law. The actions of the MTRFA Board and Executive Director are inconsistent with their roles as public pension plan fiduciaries.

Based on the foregoing discussion of facts and Minnesota law, we make the following findings of legal noncompliance:

1. Diversion of Money From the MTRFA Special Retirement Fund

Minnesota law and the MTRFA Articles of Incorporation require all of the assets of a teachers retirement fund association to be part of its special retirement fund.⁷⁰ This money must be spent from the special retirement fund for appropriate pension plan expenses and to pay authorized benefits to plan members and beneficiaries. Public pension plans, including the MTRFA, have no authority to disburse funds from the special retirement fund to place them elsewhere under a third-party trustee.

2. Placing Pension Plan Assets With a Third-Party Trustee

In addition to the lack of authority to create the Liquidating Trust, Minnesota law affirmatively states how pension fund assets must be held. The law requires that the MTRFA's pension assets must be held by the plan treasurer, the State Board of Investment or their depository agents.⁷¹ We find that the MTRFA violated this law by placing pension plan assets in the hands of the third-party Liquidating Trustee.

3. Violation of the Exclusive Benefit Law

In Minnesota, money in government pension plans can only be used for the beneficiaries of the pension plan, in this case, active and retired Minneapolis teachers. Several laws express the importance of using pension funds for the benefit of pension plan beneficiaries. For example, pension plan assets are dedicated to the payment of benefits or reasonable administrative expenses.⁷² The law also provides that the public pension plans are for the "exclusive benefit" of plan members and plan beneficiaries. In this regard, "[t]he public plans and funds *are established and must be maintained for the exclusive benefit of the members and the beneficiaries of the members.*"⁷³ Finally, in general, "no part of the moneys of the plans and funds may revert to the plan or fund or

⁷⁰ Minn. Stat. § 354A.021, subd. 3 (2004); MTRFA Restated Articles of Incorporation, § 10.1.

⁷¹ Minn. Stat. § 356A.06, subd. 1 (2004).

⁷² Minn. Stat. § 356.63 (a) (2004).

⁷³ Minn. Stat. § 356.001, subd. 1 (b) (2004). *Emphasis added.*

be used for or diverted to purposes other than the exclusive benefit of the members or their beneficiaries.”⁷⁴

The board of trustees of a public pension plan by definition holds pension plan assets for the benefit of others – plan members and their beneficiaries. In sharp contrast, the Liquidating Trust Agreement expressly states it is created primarily for the benefit of the MTRFA Board and Executive Director, not for retired Minneapolis teachers.⁷⁵ We find that the MTRFA Board of Trustees violated the exclusive benefit law by placing over \$1.5 million from the MTRFA Special Retirement Fund into the Liquidating Trust without there being an exclusive benefit to the plan members and beneficiaries.

4. Minnesota Fiduciary Law – Prohibited Transaction

The diversion of pension fund assets into the Liquidating Trust for the benefit of the MTRFA Board of Trustees and the Executive Director is also a prohibited transaction under Minnesota’s fiduciary laws.

Under the Minnesota Public Pension Fiduciary Responsibility Act, “[n]o fiduciary of a covered pension plan may engage in a prohibited transaction or allow the plan to engage in a transaction that the fiduciary knows or should know is a prohibited transaction.”⁷⁶ The definition of prohibited transaction includes:

*The transfer of plan assets to a plan fiduciary for use by or for the benefit of the fiduciary, other than the payment of retirement plan benefits to which a fiduciary is entitled or the payment to a fiduciary of a reasonable salary and of necessary and reasonable expenses incurred by the fiduciary in the performance of the fiduciary’s duties.*⁷⁷

We find that the MTRFA Board committed a prohibited transaction by taking money from the special retirement fund, placing it under the control of its own trustee, and naming itself and its Executive Director as the new beneficiaries.

5. Asset Transfer Required by the Consolidation Legislation

We find that the MTRFA failed to transfer its entire assets in violation of the Consolidation Legislation. The Consolidation Legislation required the MTRFA to transfer to the TRA by June 30, 2006, the entire assets of the special retirement fund.⁷⁸

⁷⁴ See Minn. Stat. § 356.001 (2004). The only exceptions are statutory provisions for payment of allowable “necessary reasonable, and direct” expenses of the plan or fund and payment or deposit of accrued benefits to plan members or beneficiaries under specified circumstances. See Minn. Stat. § 356.001, subds. 2, 3 (2004).

⁷⁵ As discussed previously, the members of the MTRFA Board of Trustees and the MTRFA Executive Director are named individually as the “Initial Beneficiaries” of the Liquidating Trust. Creditors are “Secondary Beneficiaries,” and the TRA is the “Tertiary Beneficiary.” Members of the MTRFA and their beneficiaries are not beneficiaries of the Liquidating Trust although the assets for the Trust were originally held in the MTRFA Special Retirement Fund for their exclusive benefit.

⁷⁶ Minn. Stat. § 356A.06, subd. 9 (2004).

⁷⁷ Minn. Stat. § 356A.06, subd. 9 (5) (2004). *Emphases added.*

⁷⁸ The special retirement fund is required to include “all of the assets” of the MTRFA. Minn. Stat. § 354A.021, subd. 3 (2004).

In addition, it provided that the MTRFA would be unable to incur any new or additional contractual liability or obligation without the TRA's approval after the day following the Consolidation Legislation's date of final enactment (May 27, 2006). The final version of the Consolidation Legislation passed the Minnesota Legislature on May 20, 2006. With these requirements of the Consolidation Legislation looming, the MTRFA obtained the services of the Liquidating Trustee on May 22, 2006 and transferred over \$1.5 million out of the MTRFA Special Retirement Fund on May 26.

The Liquidating Trust Agreement specifically notes that the MTRFA Board had no intention of turning over the entire special retirement fund to the TRA as required by the Consolidation Legislation. It states that the MTRFA contemplates it would "authorize the transfer of the Special Retirement Fund of the MTRFA to the TRA, (less any amounts to be transferred to this Liquidating Trust)." ⁷⁹ In keeping with this recital, \$1.5 million from the special retirement fund was diverted to the Trust, rather than transferred to the TRA by June 30 as required by the Consolidation Legislation. ⁸⁰

6. Perpetuation Beyond Consolidation

The MTRFA Board, by approving the Liquidating Trust Agreement, purports to give powers to the Liquidating Trustee that it did not have and could not delegate or grant. The MTRFA was a public pension plan created by state law. ⁸¹ The MTRFA was not a nonprofit corporation with general tax-exempt purposes. Like any entity created by statute, the MTRFA had only those powers granted by the legislature, and its Articles of Incorporation acknowledged its limited purpose. ⁸² The MTRFA Board, however, through the Liquidating Trust, has attempted to extend its existence beyond June 30, 2006. In the Liquidating Trust Agreement, specifically anticipating consolidation, the MTRFA purports to delegate its authority to approve the payments of claims beyond its existence by appointing a trustee to approve and pay bills in its absence. Under both the proposed and the enacted legislation, the MTRFA Board did not exist after June 30, 2006. It could not delegate to someone else the authority to approve and pay claims after that date. Instead, the authority to audit, approve, and pay claims moved by operation of statute to the MTRFA's legal successor in interest, the TRA.

The same is true of indemnification. The MTRFA's authority to indemnify its fiduciaries was statutory and ceased when it ceased to exist. The authority to indemnify its fiduciaries for claims arising after June 30, 2006, transferred to the TRA. The MTRFA Board no longer had that authority since it would not exist after that date. Consequently, it could not delegate or grant this authority to the Liquidating Trustee.

⁷⁹ Liquidating Trust Agreement, p. 4.

⁸⁰ The failure to transfer this \$1.5 million to TRA as required by the Consolidation Legislation may also violate Minn. Stat. § 609.445 (2004) (Failure to pay over state funds).

⁸¹ Minn. Stat. § 354A.021

⁸² As discussed above, provisions of the MTRFA's Restated Articles of Incorporation specifically acknowledge that the MTRFA is governed by Minnesota's pension plan laws and that its purpose is limited to providing for a fund to pay benefits to MTRFA members. *See* MTRFA Restated Articles of Incorporation, Preamble, Article 3.

The MTRFA was required to keep all of its assets in its special retirement fund.⁸³ The Consolidation Legislation mandated that all assets in the special retirement fund be transferred to the TRA. The MTRFA had no grant of authority or power to defy this legislative mandate, and it could not therefore delegate any authority to an agent or trustee to circumvent this legislative mandate.

7. Consolidation Legislation -- Payment of Claims

We find that the text of the Liquidating Trust Agreement and the manner in which it was created demonstrate an intent to usurp the consolidation process designed and enacted by the Legislature. In addition to refusing to transfer all of its money over to the TRA, the MTRFA sought to create a substitute system of bill processing and indemnification contrary to the explicit terms of the Consolidation Legislation.

The purported justifications for the Liquidating Trust contradict the clear provisions of the Consolidation Legislation. As noted, the Consolidation Legislation specified that the TRA stepped into the shoes of the MTRFA as “the successor in interest” for all claims against the former MTRFA.”⁸⁴ In addition, the Consolidation Legislation transferred all of the MTRFA’s contracts, records, and obligations to the TRA.⁸⁵ As successor in interest, the TRA also has the right and obligation to review claims, audit them and decide whether and how they should be settled.

The Liquidating Trust Agreement, however, alleges that based on communications with the TRA Executive Director and the text of the Consolidation Legislation, the MTRFA Board and Executive Director “reasonably believe” that if the Consolidation Legislation passed, the MTRFA liabilities and obligations would not be paid.⁸⁶ The document then sets out a non-exclusive list of the liabilities and obligations of the MTRFA that supposedly might not be paid due to the Consolidation Legislation.⁸⁷ The list includes such items as “contracts, debts and expenses,” indemnification of the MTRFA fiduciaries, premiums for fiduciary insurance, operating expenses, amounts due to the Executive Director and various fees owed to professional advisers and the Liquidating Trustees. These are collectively referred to as “Obligations.”

The Liquidating Trust Agreement also states that it is intended “to pay the Obligations if a law is enacted which requires the Special Retirement Fund of the [MTRFA] to be transferred to TRA, and TRA is thereafter unable or unwilling to

⁸³ Minn. Stat. § 354A.021, subd. 3 (2004).

⁸⁴ Minn. Stat. § 354.70 subs. 5 (b), 7 (b) (2006) (The only exception was claims “founded upon a claim of breach of fiduciary duty, where the act or acts constituting the claimed breach were not done in good faith.”).

⁸⁵ Minn. Stat. § 354.70, subd. 7 (a) (2006).

⁸⁶ Liquidating Trust Agreement, p. 2 (“The Executive Director has informed the Board of Trustees of communications between the Executive Director and the Executive Director of TRA. Based upon such communications, and upon the proposed form of legislation pending in the Minnesota state legislature, the Board of Trustees and the Executive Director of [MTRFA] reasonably believe that in the event the State Legislature passes and the Governor signs the proposed legislation to transfer the funds of the [MTRFA] to TRA, the [MTRFA] may not have the ability or sufficient funds to pay when due all liabilities and obligations of MTRFA which it is legally bound to pay”).

⁸⁷ Liquidating Trust Agreement, pp. 2-3.

pay what the Liquidating Trustee determines to be lawful Obligations of the [MTRFA].”⁸⁸

We find that the Liquidating Trust ignores the legal status of the TRA as successor in interest for the payment of claims and obligations. As of the consolidation, the MTRFA no longer exists. As the successor in interest for the payment of claims against the former MTRFA, the TRA is obligated to pay such claims. Any person who believes they were owed payment by the MTRFA must, under the Consolidation Legislation, seek payment from the TRA.

In addition, in contravention of the Consolidation Legislation, the Liquidating Trust Agreement purports to give the Liquidating Trustee sole authority to determine whether claims against the former MTRFA are legitimate and then to pay them. Payment is made with money that should have been transferred to the TRA by June 30, 2006. Thus, the Liquidating Trust usurps the explicit intent of the Legislature to make the TRA the successor in interest to all claims that could have been asserted against the former MTRFA.

The MTRFA Board knew that the TRA would be its successor in interest before it created the Liquidating Trust and diverted money into it from the special retirement fund. It decided, however, to defy the Legislature by managing the consolidation as it saw fit – by transferring public pension plan money to a third party trustee in violation of Minnesota law.

Furthermore, the MTRFA Board itself paid all or almost all the bills that it pretended to create the Liquidating Trust to pay. The payment of these bills by the MTRFA demonstrates that the Liquidating Trust was unnecessary for this purpose and that the MTRFA knew as much. When the underlying bills were paid, the MTRFA Board should have immediately shut down the Liquidating Trust and returned the money to the MTRFA Special Retirement Fund for transfer to the TRA for the benefit of retired Minneapolis teachers, as required by the Consolidation Legislation.

Conclusions

- The transfer of over \$1.5 million into the Liquidating Trust violated state law that required all MTRFA assets to be part of its special retirement fund. The MTRFA Board had no authority to create a separate trust with itself and the Executive Director as the main beneficiaries.
- The transfer of money from the MTRFA Special Retirement Fund into the Liquidating Trust for the benefit of the MTRFA fiduciaries constitutes a prohibited transaction under Minnesota’s fiduciary laws.

⁸⁸ Liquidating Trust Agreement, p. 3.

- Money being held in the Liquidating Trust was withheld from the TRA, and not transferred to the TRA by June 30, 2006, as required by law.
- The Liquidating Trust purports to give the Liquidating Trustee authority to settle claims and pay bills in lieu of the TRA, the legal successor in interest of the MTRFA.

VI. ADMINISTRATIVE EXPENSES PAID BY THE MTRFA BUT ALSO INCLUDED IN LIQUIDATING TRUST FUNDING

As previously stated, the Liquidating Trust was created illegally and without legal authority. In addition, even the justifications for paying special retirement fund money into the Liquidating Trust are not supported by the evidence.

The funding amount for the Liquidating Trust was based on calculations provided to the MTRFA by Financial Advisors, LLC. In a letter dated May 26, 2006, Financial Advisors, LLC, estimated that \$1,532,178 should be placed in the Liquidating Trust to fund the “liabilities and obligations of MTRFA upon its dissolution.” On that same day, May 26, 2006, the Liquidating Trust was funded with \$1,532,178 from assets of the MTRFA’s Special Retirement Fund.

Our review of the MTRFA’s fiscal year 2006 administrative expenses shows that many of the “liabilities and obligations” identified by Financial Advisors, LLC, and used to determine the funding requirement for the Liquidating Trust, were paid by the MTRFA prior to its dissolution and consolidation with the TRA. As reflected in the Expenses and Liquidating Trust chart in the appendix, only legal and trustee fees related to the illegally created Trust itself remain outstanding.

A. Administrative Expenses Paid by the MTRFA

The MTRFA paid its bills before consolidation even though it justified diverting special retirement fund money into the Trust by alleging the same bills might not get paid.⁸⁹ The specific amounts placed in the Liquidating Trust are analyzed in this section.

1. Severance Pay

As estimated by Financial Advisors, LLC, \$571,865 was placed in the Liquidating Trust for severance obligations. However, the MTRFA paid the severance packages on June 20, 2006, before it was dissolved.⁹⁰ The TRA has assumed the vacation pay-out obligations for former MTRFA staff now employed with the TRA. As a result, the

⁸⁹ Liquidating Trust Agreement, p. 2 (“the Board of Trustees and the Executive Director of [MTRFA] reasonably believe that in the event the State Legislature passes and the Governor signs the proposed legislation to transfer the funds of the [MTRFA] to TRA, the [MTRFA] may not have the ability or sufficient funds to pay when due all liabilities and obligations of MTRFA which it is legally bound to pay . . .”).

⁹⁰ See MTRFA Board of Trustees Meeting minutes – June 7, 2006 (Item 7).

\$571,865 placed in the Liquidating Trust for severance packages should be transferred to the TRA.

2. Lease Obligations

Financial Advisors, LLC, calculated the MTRFA's total lease obligations for the occupancy period of July 1, 2006, through January 31, 2009.⁹¹ The MTRFA's Executive Director informed us that she personally negotiated the MTRFA's lease. She negotiated a five-year lease in 2003, extending the lease from January 2004 through January 2009. Despite the possibility of consolidation, the lease did not contain a termination provision allowing termination of the lease by the MTRFA in the event of a consolidation. The lease does, however, permit the landlord to terminate the lease with at least three days' written notice if the MTRFA's interest in the lease passes to another party by law.⁹² As a result, the Liquidating Trust contains \$141,398 set aside for lease obligations.

The TRA assumed the MTRFA's lease obligations.⁹³ The Minnesota Department of Administration, on the TRA's behalf, has given notice to terminate the lease. It relied upon Minn. Stat. § 16B.24, subd. 6, which provides that leases for state purposes are subject to cancellation upon 30 days written notice by the State for any reason except lease of other non-state-owned land or premises for the same use. We understand the landlord disputes the TRA's claim. The Consolidation Legislation recognizes that the TRA can assert contractual defenses it has by reason of its status as a state agency.⁹⁴ This dispute is between the TRA and the landlord. The Liquidating Trust should not be involved in this dispute because the TRA has legally assumed this obligation. Therefore, the \$141,398 placed in the Liquidating Trust for lease obligations should be transferred to the TRA.

3. Fiduciary Liability Insurance

As estimated by Financial Advisors, LLC, \$156,776 was placed in the Liquidating Trust for fiduciary liability insurance.⁹⁵ However, the MTRFA paid for six years of tail coverage on June 20, 2006, before it was dissolved.⁹⁶ As a result, the \$156,776 placed in the Liquidating Trust for fiduciary liability insurance should be transferred to the TRA.

4. Investment Management Fees

As estimated by Financial Advisors, LLC, \$305,000 was placed in the Liquidating Trust for professional fees related to investment management services and investment

⁹¹ See Exhibit 8 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

⁹² See Baker Center Lease of Office Space (December 2, 1987) at 19.03 (d). The lease also allows for assignment of the lease. *Id.* at 11.01.

⁹³ We understand that the TRA budgeted money for this obligation and paid the August rent.

⁹⁴ 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 5 (3).

⁹⁵ See Exhibit 9 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

⁹⁶ The six-year tail coverage cost \$118,996, and an additional \$59,498 had also been paid for fiduciary liability coverage effective April 6, 2006. The sum of these two payments for fiduciary insurance is \$178,494. These payments provide fiduciary liability insurance and tail coverage from April 6, 2006 through June 30, 2012.

custodian services.⁹⁷ The TRA's duty pursuant to the Consolidation Legislation was acknowledged in a series of letters sent by the MTRFA Executive Director to the money managers on May 31, 2006, directing them to submit future bills directly to SBI on the TRA's behalf. Indeed, the TRA has assumed those obligations.⁹⁸ Therefore, the \$305,000 placed in the Liquidating Trust for professional fees related to investment services should be transferred to the TRA.

5. Payroll Processing Fees

As estimated by Financial Advisors, LLC, \$19,050 was placed in the Liquidating Trust for professional fees related to annuity and employee payroll processing.⁹⁹ However, as set forth in a May 18, 2006, letter to the MTRFA's Executive Director, the TRA assumed that obligation. The TRA has been paying those bills. Therefore, the \$19,050 placed in the Liquidating Trust for annuity and employee payroll processing was not necessary, and the funds should be transferred to the TRA.

6. Accounting Services Fees

As estimated by Financial Advisors, LLC, \$20,000 was placed in the Liquidating Trust for professional fees related to accounting services.¹⁰⁰ Specifically, the fees were for: 1) determining funding requirements for the Liquidating Trust; and 2) preparing the MTRFA's tax returns for the fiscal year ending June 30, 2006. Before it was dissolved, the MTRFA paid Financial Advisors, LLC, \$10,000 for its services in determining the amount to be placed in the Liquidating Trust.¹⁰¹ In a letter dated May 2, 2006, the TRA informed the MTRFA's Executive Director that the TRA would assume responsibility for the filing of the MTRFA's tax forms.¹⁰² Therefore the \$20,000 placed in the Liquidating Trust for accounting services should be transferred to the TRA.

7. Doctors' Fees

As estimated by Financial Advisors, LLC, \$7,500 was placed in the Liquidating Trust for doctors' fees for medical services rendered in evaluating teachers for permanent disability.¹⁰³ The TRA has paid doctors' fees and has assumed any additional obligations

⁹⁷ See Exhibit 10 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

⁹⁸ The State Auditor's Office has been informed that SBI is paying the fees and allocating them to TRA's expenses.

⁹⁹ See Exhibit 10 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

¹⁰⁰ See Exhibit 10 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

¹⁰¹ We note that Financial Advisors, LLC, was paid \$10,000. According to the engagement letter, Financial Advisors, LLC, was to provide monthly invoices detailing their hourly fees and expenses. The invoices we were provided had no such detail.

¹⁰² In response, the MTRFA Executive Director sent TRA a memorandum dated May 16, 2006 noting that MTRFA's legal counsel advised that MTRFA's federal tax ID number belongs to the non-profit corporation, not to the pension fund, and could not be used by another entity. TRA informed us that the former MTRFA employee (currently a TRA employee) who helped prepare MTRFA's taxes in the past will help prepare the taxes. TRA plans to handle the tax preparation internally or hire assistance if needed.

¹⁰³ See Exhibit 10 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

in this area. Therefore, the \$7,500 placed in the Liquidating Trust for doctors' fees should be transferred to the TRA.

8. Member Communications

As estimated by Financial Advisors, LLC, \$21,300 was placed in the Liquidating Trust for membership communication.¹⁰⁴ Specifically, the estimated costs reflected three mailings and a "final meeting." The TRA paid these costs. Therefore, the \$21,300 placed in the Liquidating Trust for membership communication should be transferred to the TRA.

B. Remaining Liquidating Trust Obligations

We were informed that the only invoice the Liquidating Trustee had received for payment from the Liquidating Trust as of August 30, 2006, was a bill for \$78,365 for costs and legal services provided by Best & Flanagan, attorneys for the Trustee, for the time period of May 25, 2006, (inception) through the end of July 2006.¹⁰⁵

It is anticipated that additional legal fees will be submitted. In addition, trustee fees have not yet been submitted. Based upon the Financial Advisors, LLC, estimate, \$100,000 was placed in the Liquidating Trust for legal fees, and \$50,000 was placed in the Liquidating Trust for trustee fees.¹⁰⁶ Unless the Liquidating Trust is speedily dissolved, it appears the legal and trustee fees to perpetuate the illegally created trust will surpass those amounts.

A 10% contingency reserve of \$139,289 was added to the Liquidating Trust. The Liquidating Trust legal fees generated by the Liquidating Trustee and his attorney may consume this amount as well.

C. Liquidating Trustee Refusal to Turn Money over to the TRA

By way of a letter and fax dated July 25, 2006, TRA attorney Jon Murphy identified expenses either already paid or assumed by the TRA that had provided the basis for funding the Liquidating Trust. Exhibits to the letter showed that the MTRFA had paid \$681,640.04 of the obligations, and an additional \$700,537.96 in obligations had been paid or assumed by the TRA, or no longer existed. The TRA requested that the Liquidating Trustee release the \$1,382,178 in obligations to the TRA. The attorney for the Liquidating Trustee responded by way of a letter dated September 8, 2006, denying the TRA's requests that the Trustee release money to the TRA.¹⁰⁷ The letter stated that perhaps the most important reason for denying the requests was that "the Liquidating Trustee does not have the power to pay a claim of the TRA prior to the termination of the

¹⁰⁴ See Exhibit 11 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

¹⁰⁵ August 30, 2006 Heffelfinger Letter to State Auditor's Office.

¹⁰⁶ See Exhibit 10 to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

¹⁰⁷ See September 8, 2006 Heffelfinger letter to Assistant Attorneys General DeMeules and Murphy.

Trust.” It explained that the Liquidating Trust can pay the obligations of the former MTRFA, the MTRFA Board and Executive Director, and creditors; but not the TRA.¹⁰⁸

According to the Liquidating Trustee’s attorney, the TRA’s requests were also denied because the TRA’s interest in the money in the Liquidating Trust was limited to the remainder of the trust upon its termination. The letter pointed out that “TRA is designated as the ‘Tertiary Beneficiary’ whose interests in the corpus of the Trust are subservient to those of the Initial Beneficiaries [the MTRFA Board and Executive Director] and Secondary Beneficiaries [creditors].”¹⁰⁹

Essentially, even though creditors have been paid, the interests of the MTRFA Board and Executive Director come before those of the TRA and the retired Minneapolis teachers who are now TRA members. These rationales for the refusal to forward the diverted special retirement fund money to the TRA demonstrate that the Liquidating Trust was not designed to effectuate the Consolidation Legislation, but to frustrate it. The money will apparently be withheld until either the Trustee determines that all statutes of limitations have expired, or the state bows to the coercive demands built into the Trust by the MTRFA before it ceased to exist.

Conclusions

- The MTRFA Board diverted \$1,532,178 from the MTRFA Special Retirement Fund to a Liquidating Trust, based on the estimated costs of certain claims and obligations.
- Except for legal and trustee costs related to the illegally created Liquidating Trust itself, all of the claims and obligations upon which the amount diverted to the Liquidating Trust was based have either been paid or assumed by the TRA. All of these amounts should be released to the TRA.

VII. LACK OF NECESSITY FOR, AND COERCIVE CONDITIONS OF, THE LIQUIDATING TRUST

In addition to violating the law and being unnecessary as a practical matter for the payment of obligations, the Liquidating Trust was not needed to obtain indemnification. It was evident before the creation of the Liquidating Trust that the TRA would pay the MTRFA’s bills and that the MTRFA Board Members and Executive Director would receive indemnification. The Liquidating Trust exists today not to pay bills or to provide indemnification, but to coerce the State of Minnesota into agreeing to demands that the MTRFA built into the Liquidating Trust Agreement.

As demonstrated above, the MTRFA paid its bills before its dissolution, and the TRA assumed any remaining obligations under the Consolidation Legislation. It is also clear that the Liquidating Trust was not needed to provide post-consolidation indemnification

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* The letter goes on to say that the Liquidating Trust is empowered to pay any liability or obligation the MTRFA “is legally bound to pay,” not just those for which money was placed in the Trust.

to the MTRFA Board and Executive Director. First, before its dissolution, the MTRFA purchased six years of fiduciary tail coverage insurance for the MTRFA Board and the Executive Director. The insurance cost the MTRFA \$118,996.

Second, although we understand that the former MTRFA fiduciaries now argue they should be covered under the indemnification provisions of the Minnesota Nonprofit Corporation Act, Minn. Stat. ch. 317A, the MTRFA is assured of fiduciary indemnification from the TRA through the Consolidation Legislation. The Consolidation Legislation states:

The Teachers Retirement Association *shall indemnify* any former fiduciary of the Minneapolis Teachers Retirement Fund Association consistent with the provisions of the Public Pension Fiduciary Responsibility Act, in section 356A.11.¹¹⁰

Minn. Stat. § 356A.11, in turn, specifically provides indemnification “from liability for fiduciary breach” to “[a] fiduciary who is a member of the governing board of a pension plan . . . or who is an employee of a covered pension plan.”¹¹¹ Minnesota Statutes Chapter 317A specifically acknowledges that the powers potentially available to nonprofit corporations are only available to a particular corporation “subject to the limitations provided in applicable federal or state law or in its articles or bylaws.”¹¹² A teachers’ retirement association’s authorities are therefore limited by the applicable pension laws, including in the MTRFA’s case, the Consolidation Legislation.

The Consolidation Legislation mandates that the TRA indemnify the MTRFA fiduciaries pursuant to the statutory indemnification provision that specifically applies to pension plans and the employees of “covered pension plans,” including the MTRFA. It contemplates that the TRA, consistent with its status as the successor in interest to the MTRFA, is obligated to assume the indemnification obligation for all fiduciary liability claims based on acts not done in bad faith.¹¹³

Because the Liquidating Trust Agreement justifies itself by alleging that the MTRFA Board and Executive Director reasonably believed, based on the Consolidation Legislation and communications with the TRA Executive Director, that the MTRFA liabilities and obligations might not be paid, the State Auditor’s Office also reviewed

¹¹⁰ Minn. Stat. § 354.70, subd. 5 (B) (4) (2006). *Emphasis added*.

¹¹¹ The MTRFA is a “pension plan” and a “covered pension plan” under the applicable definitions. First, Minn. Stat. § 356A.01, subd. 20, defines “pension plan” to mean “all aspects of an arrangement between a public employer and its employees concerning the pension benefit coverage provided to the employees.” Second, Minn. Stat. § 356A.01, subd. 8, defines “covered pension plan” to mean “a pension plan or fund listed in section 356.20, subdivision 2” The MTRFA is listed in Minn. Stat. § 356.20, subd. 2, as a covered pension plan.

¹¹² Minn. Stat. § 317A.161, subd. 1 (2004).

¹¹³ See Minn. Stat. § 354.70, subd. 5 (2006). In contrast to the indemnity provisions of the Consolidation Legislation and Minn. Stat. § 356A.11 that specifically apply to the MTRFA and to pension plan fiduciaries respectively, the indemnification provision of Minn. Stat. § 317A.521 applies generally to nonprofit corporations, regardless of their nature or purpose.

correspondence between the TRA and the MTRFA Executive Directors to see whether the TRA Executive Director indicated claims would not be paid or indemnification would not be provided.

Contrary to the assertion found in the Liquidating Trust Agreement, no obligation of the MTRFA was questioned or disputed by the TRA. In fact, in a letter dated May 2, 2006, the TRA Executive Director affirmatively stated that the TRA would be responsible for all of the expenses of the MTRFA after consolidation.¹¹⁴

As for indemnification, the TRA Executive Director memorialized the TRA's understanding of the Consolidation Legislation in the May 2, 2006 letter. Of the TRA's understanding of the proposed Consolidation Legislation, her letter stated:

[The amended statutory language] would clarify that TRA is indemnifying MTRFA for acts made in good faith. That is the intent of the proposed change in language.¹¹⁵

The letter clearly commits the TRA to indemnify the MTRFA Board and Executive Director as fiduciaries for all acts taken in good faith.

The text of the Consolidation Legislation affirmatively provided for indemnification and the payment of all MTRFA obligations. Correspondence from the TRA affirmed the TRA's intent to provide indemnification and to pay all MTRFA bills. The MTRFA Executive Director therefore knew the TRA would provide indemnification and pay the bills. This did not stop the MTRFA, however, from asserting just the opposite as justification for the creation of the Liquidating Trust and the transfer to it of over \$1.5 million in pension funds. The use of the text of the Consolidation Legislation and contacts with the TRA in this way was a transparent ruse to justify the taking of pension funds for the benefit of the MTRFA Board and Executive Director.

Because the Liquidating Trust is not needed to pay liabilities and obligations of the former MTRFA, the State Auditor's Office reviewed it to determine what actual function it might perform. It is evident that the Liquidating Trust Agreement attempts to impose coercive conditions on the State of Minnesota. These extra-legal conditions must be met before the Liquidating Trustee will release to the TRA the money that should have been transferred to it on June 30, 2006.

For example, the Liquidating Trust Agreement states that the Liquidating Trustee will hold the money until the Liquidating Trustee determines the statutes of limitation for claims against the Liquidating Trust beneficiaries have all expired. No particular statute

¹¹⁴ In a responsive memorandum dated May 16, 2006, two days before the Trust document was signed by the MTRFA President, the only concern expressed by the MTRFA Executive Director regarding any of the "obligations" identified in the Trust involved the payroll services contract, the lease, and indemnification. With regard to payroll services and the lease, the TRA Executive Director immediately replied by way of letter dated May 18, 2006, indicating that TRA would assume the amended contract with the payroll service provider, and providing information needed for the assignment of the lease.

¹¹⁵ May 2, 2006 TRA Executive Director Hacking letter to MTRFA Executive Director Kilberg.

of limitations is identified. The fiduciary liability statute of limitations is three years.¹¹⁶ The statute of limitations for a general breach of statutory duty is six years.¹¹⁷ The MTRFA fiduciaries purchased a six year tail insurance for their fiduciary insurance. Since the trust document does not identify what statute of limitations is applicable, presumably, the Liquidating Trustee has a great deal of discretion in deciding which statutes may be applicable. At this time the duration of the Trust appears to be indefinite.

In order for the TRA to receive its money before this indefinite time period has run, the State of Minnesota must bow to the coercive demands of the Liquidating Trust Agreement to the satisfaction of the Liquidating Trustee. These extra-legal conditions are obstacles placed in the way of achieving the full transfer of MTRFA money to the TRA, where it can be used to pay pension benefits. The TRA can receive the diverted special retirement fund money before an indefinite statute of limitations period if the Liquidating Trustee receives:

from the State of Minnesota or an appropriate agency thereof, for the benefit of [MTRFA and the former MTRFA Board and Executive Director], **(aa)** *a full and final Release which shall be in a form satisfactory to legal counsel for the Liquidating Trustee* and shall satisfy the following requirements: Such Release shall: (1) fully and finally release the Fiduciaries from any and all claims which the State of Minnesota or any political subdivision, agency or instrumentality thereof may have or could assert as against the [MTRFA, the MTRFA Board and Executive Director,] and the Liquidating Trustee by reason of their performance of their duties; (2) indemnify, hold harmless and defend the Fiduciaries from any and all claims which the State of Minnesota, any political subdivision, agency, entity or instrumentality thereof, or any third party, may have or could assert for any reason, or for no reason, as against [MTRFA, the MTRFA Board and Executive Director], and the Liquidating Trustee, **and (bb)** *a written assumption of all MTRFA Obligations.*¹¹⁸

The Liquidating Trust is apparently a scheme to withhold money from the TRA unless the state provides indemnification even for acts performed in bad faith. It requires the state to provide a release satisfactory to the Liquidating Trustee's attorney and a written assumption of all obligations.

None of these conditions were contemplated by the Legislature when it enacted the Consolidation Legislation. Nor did the MTRFA suggest they be added during the legislative process. Instead, it concocted the Liquidating Trust in a unilateral attempt to manage the consolidation according to the preferences of the former MTRFA Board and Executive Director, in defiance of the Legislature's mandated consolidation process.

¹¹⁶ Minn. Stat. § 356A.12 (2004).

¹¹⁷ Minn. Stat. § 541.05 (2004).

¹¹⁸ Liquidating Trust Agreement, pp. 6-7. *Emphasis added.*

These provisions of the Liquidating Trust attempt to coerce release of claims and bad faith indemnification from the state. The threat is that the Liquidating Trust will continue to withhold the \$1.5 million of the Trust from its owner, the TRA, for an indefinite period of time unless the State of Minnesota meets the coercive demands built into the Trust for the benefit of the MTRFA Board and Executive Director. The Liquidating Trust is in effect holding the \$1.5 million hostage until the former MTRFA's ransom demands are met.

Conclusions

- Provisions of the Liquidating Trust that provide for the purchase of fiduciary liability insurance are unnecessary and redundant because the MTRFA purchased such insurance before it dissolved and the TRA is obligated to indemnify the MTRFA fiduciaries for all acts except those performed in bad faith.
- The Liquidating Trust purports to impose conditions on the State of Minnesota before the \$1.5 million will be transferred to the TRA, including the provision of final releases and written assumption of obligations. The release apparently must even indemnify the MTRFA fiduciaries for actions performed in bad faith. In addition, the conditions must be met to the satisfaction of the Liquidating Trustee and his attorney, not to the satisfaction of the TRA, which is the legal successor in interest to the MTRFA. These provisions of the Liquidating Trust defy the Consolidation Legislation. In effect, the Liquidating Trustee is holding \$1.5 million hostage until the ransom demands are met.
- Unless the extra-legal conditions of the Liquidating Trust are met to the satisfaction of the Liquidating Trustee and his attorney, the TRA will not receive the money diverted to the Liquidating Trust for an indefinite period of time.

VIII. TRANSFER OF OTHER ASSETS AND RECORDS

The Consolidation Legislation specifically required the MTRFA to transfer all MTRFA assets, contracts and records to the TRA. It specified that the required transfer of contracts and records be accomplished pursuant to Minn. Stat. § 15.039.

This statute, in turn, required the MTRFA to “give all contracts, books, maps, plans, papers, records and property of every description” to the TRA. It further required that “[t]he transfer shall be made in accordance with the directions of” the TRA. In accordance with this authority, the TRA Executive Director on May 2, 2006, directed the MTRFA to “maintain all records and documents currently held and not dispose of investment, financial and other administrative documents.”

In addition, as a public pension plan, the MTRFA was subject to the Minnesota record retention laws.¹¹⁹ These laws provide that public records may not be destroyed unless

¹¹⁹ See Minn. Stat. §§ 138.163, 138.17 (2004). The term "government records" is defined to mean “state and local records, including all cards, correspondence, discs, maps, memoranda, microfilms, papers,

specific record retention legal requirements are followed. Generally, records can be destroyed only pursuant to an adopted record retention schedule or an approved Application for Authority to Dispose of Records.¹²⁰ The MTRFA Board had not adopted a record retention schedule.

Our examination of the books and records of the former MTRFA and interviews we conducted, uncovered that a number of records were deleted, removed from the MTRFA's offices, or withheld beyond consolidation in violation of the Consolidation Legislation, Minn. Stat. § 15.039, and the Minnesota record retention requirements. Of particular concern was the presentation by the MTRFA Executive Director of her laptop computer with its hard drive missing to the TRA after she was told that the TRA planned to review its contents. The hard drive was either taken permanently and replaced with an erased hard drive, or actively wiped to a point where the data was totally unrecoverable and then returned to TRA. Either way, the MTRFA records it contained were destroyed in violation of Minnesota law. The details regarding assets or records withheld follow.

A. Laptop Computer Hard Drive.

The MTRFA purchased a laptop computer and assigned it to the MTRFA Executive Director.¹²¹ On June 20, 2006, the MTRFA Executive Director told a TRA representative she was having problems with the laptop and asked if she could purchase it. Because the computer was capitalized as an MTRFA fixed asset, the TRA representative explained that the laptop computer would become TRA property on June 30, 2006, and that the TRA would perform a "disk back-up and review" of the laptop.¹²²

On the afternoon of June 30, 2006, the MTRFA Executive Director provided the laptop computer to the TRA representative. However, this computer's hard drive, and therefore all of the information it contained, had been removed.¹²³ The MTRFA Executive Director, when asked, told the TRA representative that the hard drive was in the possession of a relative who was attempting to "repair" it.¹²⁴ The TRA representative asked for the name and telephone number of this relative, but the MTRFA Executive Director declined to provide them.¹²⁵ According to the TRA representative, the MTRFA

photographs, recordings, reports, tapes, writings, optical disks, and other data, information, or documentary material, regardless of physical form or characteristics, storage media or conditions of use, made or received by an officer or agency of the state and an officer or agency of a county, city, town, school district, municipal subdivision or corporation or other public authority or political entity within the state pursuant to state law or in connection with the transaction of public business by an officer or agency." Minn. Stat. § 138.17, subd. 1 (b) (1) (2004).

¹²⁰ Minn. Stat. § 138.17 (2004).

¹²¹ The Executive Director told the State Auditor's Office that the MTRFA Board approved her use of this computer for personal purposes. However, no such permission is found in any minutes recording board action, and the majority of MTRFA Board members interviewed were not aware of or could not recall any discussion of the Executive Director's personal use of this laptop computer.

¹²² July 3, 2006 letter from TRA Assistant Executive Director Wicklund to former MTRFA Executive Director Kilberg.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

Executive Director told him the laptop had personal emails on it, but nothing related to MTRFA activities.

The MTRFA Executive Director then offered to buy the TRA a new hard drive to replace the MTRFA hard drive she had removed. She was informed this was not an option because the information on the hard drive now belonged to the TRA. The MTRFA Executive Director informed the TRA representative that she would contact the TRA about the missing hard drive. On July 3, 2006, the TRA wrote a letter to the former MTRFA Executive Director demanding that she “immediately release and turn over the original, specific hard drive that was taken out of the laptop [she] used while MTRFA Executive Director.”¹²⁶ The former MTRFA Executive Director was told:

Replacing the former hard drive with another hard drive is not an acceptable alternative. Modifying or copying that hard drive without the State’s knowledge, consent, or permission is also unacceptable. Because you did not turn over the hard drive when requested to do so by TRA, we must also ask that you deliver to TRA any copies made of the hard drive or data on the hard drive.

By law, the hard drive, including the data on that hard drive, that was formerly in the laptop you used is now State property. You are violating one or more state statutes by withholding it from the State and TRA.¹²⁷

On July 10, 2006, the former MTRFA executive Director gave the TRA a hard drive that had been actively wiped to a point where the data was totally unrecoverable. This was confirmed by two analyses of the hard drive. First, TRA employed a computer expert specifically to review this hard drive. He reviewed the hard drive after it was turned over to the TRA and reported that an advanced utility tool was used to wipe the hard drive. Second, the TRA also asked Kroll OnTrack Electronic Evidence Services to examine and analyze the hard drive to determine whether files could be recovered and to determine if a data wiping utility was used on the hard drive.¹²⁸ It found an “IBM Recovery partition” on the hard drive, and that no user created files were recoverable.¹²⁹ Interestingly, “94% of the hard drive” had “an x00 pattern written across it.”¹³⁰ Kroll OnTrack concluded:

1. The existence of the IBM Recovery partition indicates that the hard drive was in use and had an active partition.
2. The x00 pattern . . . indicates that at least one partition existed and was wiped by writing x00 across all the sectors.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ Kroll Ontrack Electronic Evidence Services Analysis Report.

¹²⁹ *Id.*

¹³⁰ *Id.*

In an interview with the State Auditor's Office, the former MTRFA Executive Director said she was having trouble with the laptop computer, and she removed the MTRFA hard drive from the laptop computer herself. She said she took the laptop's hard drive to a place she found in the telephone book, but she could not recall which place. She said she wanted to retrieve files from the MTRFA hard drive. She indicated that she told the TRA she would get a hard drive, and the computer people gave her one. She told the State Auditor's Office she did not know whether the hard drive she gave the TRA was the MTRFA hard drive or a different one.¹³¹

Pursuant to a request by the State Auditor's Office, the Executive Director's attorney later provided, on September 21, 2006, a work order dated July 5, 2006 from Rolltex Computers. The attorney stated that the work order "corroborates Ms. Kilberg's testimony [that] the company could not retrieve any file off the disk."¹³²

The State Auditor's Office contacted Rolltex Computers. The Rolltex representative told the State Auditor's Office that it received a notebook computer, not just a hard drive, from the former MTRFA Executive Director on July 5, 2006. Rolltex told the State Auditor's Office the computer would not start. They were unable to recover data using boot disk utility programs, so they offered the former MTRFA Executive Director the option to either send the hard drive to OnTrack to recover the data or to use Partition Magic to recover the partitions. Rolltex ran Partition Magic and the hard drive had no data on it; but the Rolltex representative saw two partitions. Rolltex was not sure whether Partition Magic would destroy the data on the hard drive or just make it inaccessible. There had been something physically wrong with notebook computer hard drive.

As noted above, the hard drive turned in to the TRA was intentionally wiped with an advanced utility tool. It appears that either the TRA received a different hard drive from the one repaired by Rolltex, or the Rolltex-repaired notebook computer hard drive was intentionally wiped and then turned in to the TRA.

The Executive Director's taking of this hard drive violated Minnesota law in several ways. First, an MTRFA asset was taken and retained past the effective date of the consolidation, in violation of the Consolidation Legislation. It is still not clear whether the MTRFA property (the hard drive), which now belongs to the TRA, has been returned.¹³³

¹³¹ August 22, 2006 K. Kilberg interview.

¹³² September 20, 2006 letter from Paul Rogosheske to David Kenney.

¹³³ Under Minnesota law, "Whoever intentionally and without lawful right thereto, exercises a function of a public office or, having held such office and the right thereto having ceased, refuses to surrender the office or its seal, books, papers, or other incidents to a successor or other authority entitled thereto may be sentenced to imprisonment for not more than one year or to payment of a fine of not more than \$3,000, or both." Minn. Stat. § 609.44 (2004)

Second, all of the records on the laptop assigned to the MTRFA Executive Director were either intentionally erased beyond recovery or taken.¹³⁴ In either case, the Executive Director violated the Consolidation Legislation, which required the transfer of all MTRFA property, books and records to the TRA. She also violated Minn. Stat. § 15.039 by not turning over the information in accordance with the TRA's directions.¹³⁵

Finally, the record retention requirements of Minnesota law were violated because their procedures were not followed in the destruction of the records contained on the hard drive.

B. Compact Disk Containing Private Data

During the course of the Special Review, the State Auditor's Office learned of the creation of a compact disk (CD) that contained the names and addresses of all members of the MTRFA. The purpose for which it was created was stated in different ways, and it was given to an attorney and retained by him past the effective date of the consolidation.

Some background about the application of the Minnesota Data Practices Act to the information in question is helpful in understanding the seriousness of this issue. Information held by the MTRFA was classified under the Minnesota Government Data Practices Act.¹³⁶ The Act specifically classifies the "home address, date of birth, direct deposit number, and tax withholding data" of MTRFA beneficiaries and survivors as private data on individuals.¹³⁷ The Act does not allow public entities such as the MTRFA to release private data on individuals. There are various sanctions provided by statute that result from the unauthorized release of this private data.¹³⁸

Back in 1993, the MTRFA Board acted in recognition of its duty under Minnesota law to protect the names and addresses of members by adopting a nondisclosure policy entitled "Use of Private Data." This policy became part of the policies and procedures manual provided to MTRFA employees, and several former MTRFA employees told us they were aware of the seriousness with which the MTRFA Board took its responsibility to guard the private information it had on its members.¹³⁹

¹³⁴ One important example involves the Executive Director's emails. The Executive Director of MTRFA used a private AOL email account for MTRFA business. Because the hard drive from the MTRFA laptop assigned to her was erased or taken, none of these email records are available for TRA to review.

¹³⁵ See also Minn. Stat. § 609.44 (Whoever intentionally and without lawful right refuses to surrender a public office or its seal, books, papers, or other incidents to a successor may be sentence or imprisonment and fined, or both.)

¹³⁶ Minn. Stat., ch. 13 (2004), see Minn. Stat. § 13.632 (2004) (Teachers Retirement Fund Association Data).

¹³⁷ Minn. Stat. § 13.632 (2004).

¹³⁸ See, e.g., Minn. Stat. §§ 13.08, 13.09 (2004).

¹³⁹ In a letter dated September 17, 2004, MTRFA attorney Bob Butterbrodt advised the Executive Director that members' addresses, including not only those of beneficiaries identified in Minn. Stat. § 13.632, but also those of other active members, were classified as private data, and that "informed consent" would be needed from members before their names and addresses could be provided to an outside entity. The MTRFA Board approved an appeal for such informed consent on January 19, 2005.

The MTRFA policy noted that the address, birth date, direct deposit account number and tax withholding data on “members, beneficiaries, and survivors” of the MTRFA are considered private data under Minnesota law. It also expressly recognized that “[b]ecause addresses are considered private data by statute, this information cannot be distributed in any form including mailing labels.”

Both Minnesota law and MTRFA policy stress the importance of maintaining the privacy of MTRFA members’ private personal information, especially their addresses.

A former MTRFA employee informed us that on May 26, 2006, (the date the Governor signed the Consolidation Legislation) the MTRFA Executive Director asked a staff member to make her a CD containing the names and addresses of all members of the MTRFA “for a backup . . . before TRA gets in here.” The employee was aware of the MTRFA Board policy and went to her supervisor who agreed that the request was inconsistent with the policy, as they understood it. The supervisor confirmed this in an interview with the State Auditor’s Office.

Over the next few weeks, the Executive Director asked this employee four additional times for the CD. On June 13, 2006, the Executive Director made her fifth request to the employee. The employee told the State Auditor’s Office that when she expressed her concern at the request being made of her, the Executive Director fired her. The Executive Director confirmed that the request had been made several times but characterized the employee’s response to her fifth request as disrespectful and insubordinate.

Thereafter, both the employee and her supervisor appealed to the MTRFA Board President who told them she would look into the matter. The MTRFA Board President subsequently called the employee and told her she could have her job back if she submitted a letter apologizing for “insubordination” and requesting her job back. The employee also was required to create the CD for the Executive Director.¹⁴⁰

On approximately June 24, almost one month after she requested the CD, the Executive Director stated for the first time to staff that the private data on the disk was intended for the use of a Limited Medical Assistance Trust for which the MTRFA Board served as an advisory board. The Executive Director told the State Auditor’s Office that the MTRFA Board had asked her to obtain the names and addresses of members on a computer disk for the Limited Medical Assistance Trust. The MTRFA Board minutes do not reflect that the Board ever allowed or directed the release of the private addresses to the Trust. Our interviews with board members indicate that a majority of them did not recall any

¹⁴⁰ On June 20, 2006 after approximately four days of unemployment, the employee submitted a letter to the Executive Director and MTRFA Board President. This letter indicated she had become uncomfortable with the request made of her by the Executive Director. The Executive Director told the employee that the letter was unacceptable, and required her to submit a second version after deleting certain items including the section that stated that the employee was uncomfortable with the Executive Director’s request. At about this time, according to MTRFA staff interviews, the Executive Director called a meeting in which she told staff that anyone failing to follow her directives would be fired, losing not only their severance, but employment with TRA as well.

discussions regarding the request for this disk. The Executive Director told us she gave the CD to MTRFA attorney Lazarus. It was not turned over to the TRA by June 30, 2006, the date on which it became a record of the TRA.

TRA personnel were informed of the creation of the CD by former MTRFA employees on July 7, 2006. These employees had been told that the CD was to be given to MTRFA attorney Butterbrodt for the Limited Medical Assistance Trust. On July 13, 2006, TRA attorney Jon Murphy contacted Mr. Butterbrodt, who indicated he knew nothing about the CD. Since the former MTRFA Executive Director had informed the TRA that all correspondence was to be directed to attorney Lazarus, the TRA's attorney sent a letter to attorney Lazarus demanding return of the CD and outlining the statutory obligations of government entities under state law not to release private information on individuals.

In response to inquiries from the TRA's attorney, Mr. Lazarus wrote, "I did not regard Ms. Kilberg's having the disk in her possession, given the circumstances, to be of any concern to the Minnesota Attorney General or TRA. For that reason, I did not advise Ms. Kilberg that the names of retired Minneapolis teachers has risen to the level that a security clearance was needed to access the names."¹⁴¹ On about July 26, 2006, nearly a month after the MTRFA ceased to exist and all records were to have been transferred to the TRA, Mr. Lazarus mailed the CD to the TRA.

The Executive Director should not have attempted to release private data. It does not appear that the CD was made for the TRA or to administer the MTRFA. Mr. Lazarus and the MTRFA Executive Director indicated that no copy was made. However, the TRA was unable to validate that no CD was made. Even if no copy of the data was ultimately released, the retention of the CD beyond the consolidation violated the Consolidation Legislation and Minn. Stat. § 15.039.

C. Tapes

The MTRFA Board tape-recorded its meetings. It often closed its meetings, however, to go into "executive session." The "executive session" portions of the meetings were not tape-recorded. The MTRFA Governance Manual provides:

The full meeting will be recorded on a tape and maintained for at least six months. Tapes will be available for the exclusive use of the Trustees, office staff and any member upon written request in accordance with MN Statute 13.03, Subd. 3.¹⁴²

The MTRFA's Information Request policy provided that "[m]embers may have copies of board meeting audio tapes that have already been recorded, if they pay for the reproduction."¹⁴³ The State Auditor's Office requested the tapes from the MTRFA Board's June 2006 meetings, but they were gone.

¹⁴¹ July 27, 2006 Lazarus letter to Murphy.

¹⁴² MTRFA Governance Manual, p. 2.

¹⁴³ MTRFA Policies and Procedures, p. 34 (Approved by the Board June 12, 1996).

The employee responsible for making the tapes recalled that the Executive Director asked to see the tapes during June 2006. The employee informed us that they went together to the drawer where the tapes were kept, and there were approximately 20 tapes in the drawer. The employee said that the Executive Director informed her that only 12 tapes should be there, representing two tapes for each monthly meeting for the last six months, and the extra eight tapes should be thrown out. According to the employee, she then left the Executive Director with the tapes. The employee informed us that it was her understanding that the Executive Director was going to throw out the extra tapes.

During our interview, the Executive Director recalled that the employee showed her the meeting tapes, but did not recall what happened to the tapes. However, she maintained it was the policy of MTRFA to get rid of the tapes as soon as the minutes were drafted. Several MTRFA Board members also stated their belief that the intent of the policy was to keep the tapes only until after the minutes were drafted. This conflicts with the written policy adopted by the MTRFA Board and the understanding of the staff member who taped the meetings.¹⁴⁴ Further, this understanding of the policy is in conflict with the fact that the MTRFA retained 116 audio tapes of prior meetings through 1999 at its Minneapolis office.

The destruction or removal of these tapes in June 2006 violated the Consolidation Legislation. It also violated Minn. Stat. § 15.039 which required the MTRFA to turn over property and records in accordance with the TRA's directions. Finally, it violated the MTRFA Board's policy and the Minnesota record retention laws.

D. Attorney Bills

Public entities are required to keep supporting documentation for claims paid.¹⁴⁵ In 2006, the MTRFA employed a number of attorneys. Robert Butterbrodt had been the MTRFA's attorney for years. In addition, the MTRFA worked with Barry Lazarus and other attorneys at the law firm of Moss & Barnett. Finally, the MTRFA hired Thomas King, who was with the law firm of Fredrikson & Byron.¹⁴⁶

From the payment records of the MTRFA, we were able to determine that the MTRFA had paid \$103,920.19 to the law firm of Moss & Barnett and \$13,167.50 to the law firm of Fredrikson & Byron in fiscal year 2006. However, bills from these law firms were not in the MTRFA files to support all of these payments. We therefore made requests

¹⁴⁴ The State Auditor's Office also requested minutes and related documents related to the Liquidating Trust. Thereafter, we learned that notes existed for board minutes for time periods before and after the time period requested by the State Auditor's Office. We were informed by a staff member that the Executive Director instructed her to destroy, through shredding, her notes related to board minutes, after the State Auditor's Office's requested copies of minutes and related documents. The staff member said she shredded the notes. The Executive Director denied giving this instruction. It is apparent that these notes were destroyed because of the State Auditor's Office request, although the request did not specifically mention meeting notes.

¹⁴⁵ See Minn. Stat. § 15.17 (2004).

¹⁴⁶ The Liquidating Trustee is represented by Thomas Heffelfinger, with the law firm Best & Flanagan.

directly to these firms to send us copies of their bills previously submitted to and paid by the MTRFA.

The Fredrikson & Byron firm provided copies of their bills on August 15, 2006. By way of correspondence dated August 11, 2006, the firm of Moss & Barnett provided the State Auditor's Office not with copies of their bills, but with the original bills themselves. The cover letter indicated that the original bills being provided had been physically returned to the law firm by the MTRFA Executive Director.

The MTRFA Executive Director told the State Auditor's Office that she had removed these paid bills from the MTRFA files and returned them to the law firm of Moss & Barnett because she was told to do so by attorney Lazarus. According to the Executive Director, attorney Lazarus told her these bills were protected by the attorney-client privilege.

The "attorney-client privilege" is a privilege afforded communications between the client and an attorney.¹⁴⁷ The privilege belongs to the client, not the attorney. The MTRFA Board never voted to remove these bills from the MTRFA files and to return them to the law firm. They were presented to the MTRFA, a public pension plan, to support claims for the payment of public money. Because they are financial records necessary for a full and accurate knowledge of the activities of a public pension plan, the bills should not have been removed from the files of the MTRFA.¹⁴⁸

The removal of these records from the MTRFA files violated the Consolidation Legislation. It also violated Minn. Stat. § 15.039 because the TRA had directed the preservation of MTRFA records.

E. Email Correspondence

Emails sent to the MTRFA were received at a central computer in the office.¹⁴⁹ It was the practice of one staff employee to delete emails not related to MTRFA business, and then to copy emails that were related to MTRFA business for individual staff members. Once copied, the emails were placed into a computer file in the central computer and kept for several months in case they were needed.¹⁵⁰

In July 2006, when State Auditor's Office auditors arrived at the former MTRFA's offices, all of the emails had been deleted from the central computer.

¹⁴⁷ See Minn. Stat. § 595.02 (2004).

¹⁴⁸ See Minn. Stat. § 15.17 (2004). Attorney billing statements are not protected from disclosure in their entirety by the attorney-client privilege in the first place. Portions of such bills may be protected, but only if they communicate legal advice or attorney work product in the form of legal opinions, conclusions, legal theories or mental impressions prepared in anticipation of litigation. See *City Pages v. State*, 655 N.W.2d 839 (Minn. App. 2003). While a "not public" data classification would allow records to be withheld from public disclosure, it would not authorize their destruction or their entire removal from a pension plan's files.

¹⁴⁹ The Executive Director used a private AOL email account for her MTRFA-related emails.

¹⁵⁰ There was no official MTRFA Board policy on the subject of emails.

The records of a public entity should be retained for an appropriate time period. The erasure of all MTRFA emails from the central computer on the eve of consolidation, after the TRA had directed that the MTRFA retain its records, violated both the Consolidation Legislation and Minn. Stat. § 15.039.

Conclusions

- After being told she could not purchase the MTRFA laptop computer assigned to her, the MTRFA Executive Director removed the hard drive and failed to turn it over to the TRA on June 30, 2006, in violation of the Consolidation Legislation. On July 10, 2006, the MTRFA Executive Director turned over a completely erased hard drive. The hard drive was taken and retained after consolidation in violation of Minnesota law. Any records on the hard drive were not turned over to the TRA in violation of the Consolidation Legislation and Minn. Stat. § 15.039.
- A compact disk containing private data on MTRFA members was not turned over to the TRA by June 30, 2006, in violation of the Consolidation Legislation and Minn. Stat. § 15.039.
- Tapes of MTRFA Board meetings were removed from MTRFA files in violation of Minnesota the Consolidation Legislation, Minn. Stat. § 15.039, Minnesota record retention laws and the MTRFA's policies and procedures.
- MTRFA attorney bills were removed from the MTRFA files and not turned over to the TRA in a timely manner consistent with the Consolidation Legislation and the lawful direction of the TRA under Minn. Stat. § 15.039.
- MTRFA email correspondence was deleted from the MTRFA's central computer in violation of the Consolidation Legislation, Minn. Stat. § 15.039, and Minnesota record retention laws.

IX. MTRFA CONTRACT CREATED AFTER ENACTMENT OF CONSOLIDATION LEGISLATION IN VIOLATION OF LAW

The Consolidation Legislation clearly mandated that the MTRFA was required to obtain the TRA's approval before incurring any new or additional contractual liability or obligation between the day after final enactment, May 27, 2006, and June 30, 2006.¹⁵¹

¹⁵¹ Minn. Stat. 354.70, subd. 7 (2006). The statute states, in part: "Between the date of enactment of this section and June 30, 2006 the Minneapolis Teachers Retirement Fund Association cannot incur a new or additional enforceable contractual liability or obligation without the approval of the Teachers Retirement Association."

The word “incur” means “[to] become liable or subject to as a result of one’s actions; bring upon oneself.”¹⁵² Because the requirement for TRA approval became effective May 27, 2006 (the day after the Consolidation Legislation’s final enactment), all new or additional contractual liabilities or obligations incurred by the MTRFA after that date needed to be approved by the TRA.

The MTRFA paid \$118,996 by check dated June 20, 2006, to cover a six-year extension of its fiduciary liability coverage, known as “tail coverage.”¹⁵³ We spoke with the MTRFA’s insurance agent, asking when the additional tail coverage was ordered by the MTRFA. We were told that the additional coverage was ordered by the MTRFA the same day that the agent ordered the additional insurance coverage from the insurance carrier. The broker forwarded the email requesting this coverage to us, and the date is clearly June 14, 2006.

As an additional liability of \$118,996, incurred after May 27, 2006, this tail coverage expenditure should not have been made without the TRA’s approval. We reviewed the record to determine if the TRA had in any way approved this new obligation. In an email dated April 27, 2006, the Executive Director of the MTRFA asked the TRA for guidance regarding this language in the proposed statute. By way of letter dated May 2, 2006, the TRA informed the MTRFA that:

If obligations are contractually established or their budget approved prior to enactment of the bill, we believe those payments may be made under the authority of the MTRFA.

The documents provided by the insurance broker indicate that this insurance was contractually “established” after enactment, on June 14, 2006. We therefore reviewed MTRFA records regarding budgeted expenditures for fiscal year 7/1/05 to 6/31/06. Our review of the MTRFA records indicated that “fiduciary tail insurance” was not in any approved budget prior to May 27, 2006. In fact, on May 24, 2006 the MTRFA sent to the TRA a “proposed” budget for the next fiscal year, which included amounts for “insurance” of \$90,000.

After receiving this proposed budget for the following fiscal year, the TRA Executive Director sent two emails to the MTRFA Executive Director on May 26, 2006 and on May 31, 2006 asking for background information about the \$90,000 fiduciary insurance item. After receiving no written response to these emails from the MTRFA, the TRA made a telephone inquiry, but received no satisfactory explanation.

Based on the prior communications between the TRA and the MFTRA, it is questionable whether the TRA would have approved the payment for six years of additional fiduciary insurance for the MTRFA fiduciaries. The TRA had previously assured the MTRFA in

¹⁵² America Heritage Dictionary of the English Language, 4th Ed. 2000.

¹⁵³ As of September 2006, TRA could not obtain information regarding fiduciary insurance from AIG without the written consent of the MTRFA fiduciaries.

writing that its fiduciaries would be indemnified by the TRA for all acts done in good faith, arguably making this tail insurance (which also only covers good faith acts) unnecessary. The TRA should have been allowed to exercise its discretion on this expenditure as mandated by the Consolidation Legislation.

As fiduciaries, the MTRFA Board and Executive Director were bound to act in a manner consistent with state law.¹⁵⁴ This violation of the Consolidation Legislation resulted in a loss to the special retirement fund in the amount of \$118,996.

Conclusion

- Since the tail insurance policy was ordered on June 14, 2006, some seventeen days after the statute was enacted, and, further, the amount of the tail insurance was not in an adopted budget prior to May 27, 2006, and, finally, the TRA never approved this expenditure; it is our conclusion that the purchase of the fiduciary tail insurance on June 14, 2006 violated the Consolidation Legislation.

X. OPEN MEETING LAW

The State Auditor's Office reviewed the MTRFA Board's compliance with the Minnesota Open Meeting Law.¹⁵⁵ This law required all meetings of the MTRFA Board and its committees to be open to the public.¹⁵⁶ Because the Open Meeting Law was enacted for the public benefit, it is construed in favor of public access.¹⁵⁷ Before a public body closes a meeting, it must "*state on the record the specific grounds* permitting the meeting to be closed and *describe the subject to be discussed.*"¹⁵⁸

A. Meetings Closed in Violation of the Open Meeting Law

The MTRFA Board frequently closed its meetings to go into "executive session."¹⁵⁹ The minutes from these meetings often simply state such general reasons for closed meetings as "personnel issues," "administrative items," and "discussion of legal issues."¹⁶⁰

¹⁵⁴ Minn. Stat. § 356A.05 (b) (2004).

¹⁵⁵ Minn. Stat. ch. 13D (2004).

¹⁵⁶ Minn. Stat. §§ 13D.01, subd. 1 (d) (2); 356A.08, subd. 1 (2004).

¹⁵⁷ *State by Archabal v. County of Hennepin*, 505 N.W.2d 294, 297 (Minn. 1993).

¹⁵⁸ Minn. Stat. § 13D.01, subd. 3 (2004).

¹⁵⁹ The MTRFA Board went into executive session for a portion of ten meetings between January 2005 and April 2006. See 2005 MTRFA Board of Trustee meeting minutes for March 16, April 20, May 18, June 15, October 19, November 16, December 21; 2006 meeting minutes for January 18, March 15, and April 19.

¹⁶⁰ For example, on April 19, 2006, a representative of the State Auditor's Office attended the open meeting of the MTRFA Board. After attorneys Butterbrodt and Lazarus arrived; the Board President announced the Board was going into "executive session" to discuss "merger issues" and "staffing issues." The "merger issues" were to include a response to the State Auditor's April 18, 2006 information request. Although the Board remained to participate in the closed meeting, and despite his objections, the State Auditor's representative was asked to leave, and the meeting was closed. The timing of this closed meeting, the reason given (merger issues) and the participation of attorney Lazarus indicate that the diversion of special retirement fund money into the Liquidating Trust for the benefit of the MTRFA Board and Executive

A public body subject to the Open Meeting Law cannot close meetings for general personnel or staffing issues. Although a public meeting may be closed “to evaluate the performance of an individual who is subject to its authority,” specific procedures must be followed.¹⁶¹ First, the public body must identify the individual to be evaluated prior to closing the meeting. Then, at the next open meeting, the public body must summarize its conclusions regarding the evaluation.¹⁶²

Similarly, while a public meeting may be closed “if the closure is . . . permitted by the attorney-client privilege,”¹⁶³ the legal standards for this type of closure were not met by the MTRFA Board. The attorney-client privilege exception to the Open Meeting Law applies only when there is a need for absolute confidentiality.¹⁶⁴ For this reason, the scope of the privilege is narrower for public bodies than it is for private clients.¹⁶⁵ In fact, the attorney-client privilege available to public bodies is constrained by the Open Meeting Law.¹⁶⁶ The long-standing rule, established by the Minnesota Supreme Court, is that “[t]he exception . . . is to be employed or invoked cautiously and seldom in situations other than in relation to threatened or pending litigation.”¹⁶⁷ In 2002, the Supreme Court ruled it is clear that “when a public body is deciding a matter within its jurisdiction,” even “the threat that litigation might be a consequence of deciding the matter one way or another does not, by itself, justify closing the meeting.”¹⁶⁸

Since 1976, the clear standard set forth by the Minnesota Supreme Court has been that:

[t]he attorney-client exception . . . would almost never extend to the mere request for general legal advice or opinion by a public body in its capacity

Director was a likely topic of this closed meeting. The MTRFA Board minutes simply state the meeting was closed “to confer with legal counsel.”

In a subsequent April 25, 2006 letter responding to a State Auditor’s Office request for information, the Board President defended closure of the meeting by noting that in a press release the State Auditor had strongly criticized the recent extension of the term of the MTRFA Executive Director’s contract to June 30, 2007. The MTRFA considered that this constituted threatened litigation and the attorney-client privilege could be invoked.

¹⁶¹ Minn. Stat. § 13D.05, subd. 3 (a) (2004).

¹⁶² *Id.*

¹⁶³ Minn. Stat. § 13D.05, subd. 3 (b) (2004).

¹⁶⁴ *Prior Lake American v. Mader*, 642 N.W.2d 729, 737 (Minn. 2002).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Minneapolis Star & Tribune Co. v. Hous. & Redev. Auth.*, 251 N.W.2d 620, 626 (Minn. 1976) *quoted in Mader*, 642 N.W.2d at 738. In *Brainerd Daily Dispatch v. Dehen*, 693 N.W.2d 435 (Minn. App. 2005), the Minnesota Court of Appeals found the legal standard for invoking the privilege was met. In that case, an organization stated that it would seriously consider legal action if it were excluded from a parade. A Minnesota Civil Liberties Union (MCLU) panel recommended that the MCLU represent the organization in possible legal action. The city then contacted its insurer, which retained an attorney to represent the city in the dispute. The insurer-provided attorney appeared at the meeting in question. Before the meeting was closed, the attorney “assured the council and members of the public that the discussion would be limited to litigation strategy and that no other public business would be addressed.” *Brainerd Daily Dispatch*, 693 N.W.2d at 437-438.

¹⁶⁸ *Mader*, 642 N.W.2d at 740.

as a public agency. We cannot emphasize too strongly that should this exception be applied as a barrier against public access to public affairs, it will not be tolerated, for this court has consistently emphasized that respect for and adherence to the First Amendment is absolutely essential to the continuation of our democratic form of government.¹⁶⁹

The MTRFA Board of Trustees closed its meetings to go into “executive session” in violation of the Open Meeting Law. In doing so, the MTRFA Board closed meetings for general discussions regarding personnel without following the statutory procedures required for closed meetings to evaluate the performance of identified individual employees. The MTRFA Board also closed meetings for general discussions with legal counsel, improperly using the attorney-client privilege as a barrier against public access to public affairs.

B. Special Meeting Notices Did Not State the Purpose of the Special Meetings

Minnesota law mandates notice requirements that must be followed for meetings of a public body subject to the Open Meeting Law.¹⁷⁰ The schedule of regular meetings must be kept on file at the primary offices of a public body.¹⁷¹ For a special meeting, or a regular meeting held at a time or place different from that listed on the schedule of regular meetings, the notice must be posted on the public body’s principal bulletin board or on the door of its usual meeting room three days before the meeting.¹⁷² The notice for a special meeting must also state the purpose of the meeting.¹⁷³

The State Auditor’s Office interviewed former MTRFA staff and reviewed copies of notices posted for MTRFA Board meetings. According to the staff person responsible for preparing and posting notices, the notices posted for special meetings did not state the purpose of the special meetings. Thus, the MTRFA Board of Trustees did not follow the notice requirements of the Open Meeting Law for special meetings, including the special meeting on May 8, 2006, at which the Liquidating Trust was approved, and a special meeting on June 7, 2006.

Conclusions

- The MTRFA Board closed meetings for “executive sessions” on several occasions in violation of the Minnesota Open Meeting Law. On at least one occasion, it is

¹⁶⁹ *Minneapolis Star & Tribune Co. v. Hous. & Redev. Auth.*, 251 N.W.2d 620, 626 (Minn. 1976), *quoted in Mader*, 642 N.W.2d at 736-37.

¹⁷⁰ The notice requirements apply to closed as well as open meetings. *See* Minn. Stat. § 13D.04, subd. 5 (2006).

¹⁷¹ Minn. Stat. § 13D.04, subd. 1 (2004).

¹⁷² Minn. Stat. § 13D.04, subd. 2 (a) & (b) (2004). The notice must also be mailed or delivered to people who have filed a written request for notice of special meetings; or, as an alternative, the notice can be published, at least three days before the meeting in the newspaper.

¹⁷³ Minn. Stat. § 13D.04, subd. 2 (a) (2004).

likely that the Liquidating Trust was discussed at an improperly closed “executive session.”

- The MTRFA violated the Minnesota Open Meeting Law by not posting notice of the purpose for its special meetings. This violation contributed to the secrecy surrounding creation of the Liquidating Trust.

XI. ADMINISTRATIVE EXPENSES

The State Auditor’s Office reviewed the MTRFA’s total administrative expenses, including administrative expenses related to investments and real estate. The MTRFA’s total administrative expenses for fiscal year 2006 were \$1,632,755. In both fiscal year 2004 and 2005, the MTRFA’s total administrative expenses were under \$1 million.¹⁷⁴ The major increases during fiscal year 2006 were found to be in salaries and employee benefits, legal fees, and insurance.

A. Salaries and Employee Benefits

Salaries increased \$387,614 from fiscal year 2005 to 2006.¹⁷⁵ Employee benefits increased \$67,519 from fiscal year 2005 to 2006.¹⁷⁶ Most of the increase is attributable to severance packages paid by the MTRFA on June 20, 2006.¹⁷⁷ For more detail, see the MTRFA Total Administrative Expenses chart in the appendix.

The Executive Director’s final MTRFA compensation and benefit package cost \$357,385. It was comprised of the following components:

- 1) \$147,611 for payment on her contract which ended July 1, 2007 (one year salary);¹⁷⁸
- 2) \$73,806 for six months severance;¹⁷⁹
- 3) \$19,871 for 35 accrued vacation days;¹⁸⁰

¹⁷⁴ See Chart: MTRFA Total Administrative Expense (Including Expenses Charged to Investing Activity and Real Estate). Administrative expenses for 2005 were \$982,753; administrative expenses for 2004 were \$978,853.

¹⁷⁵ In 2005, salaries were \$472,145; in 2006, salaries were \$859,759.

¹⁷⁶ In 2005, employee benefits were \$76,373; in 2006, employee benefits were \$143,892.

¹⁷⁷ Payroll taxes increased from \$33,125 in 2005 to \$52,017 in 2006.

¹⁷⁸ See March 15, 2006 Addendum to Executive Director’s Employment Agreement effective July 1, 2001, Section 1 (extends Agreement through June 30, 2007) and 5.3.1 (requires lump sum payment through the balance of the Agreement term); see also MTRFA Board of Trustee’s meeting minutes March 15, 2006.

¹⁷⁹ See MTRFA Employee Handbook updated January 2006, Section 6 (on last day of employment, employee receives one month salary for each year of employment, up to a maximum of six months salary. The provisions of the MTRFA Employee Handbook were applied to the Executive Director in Section 7.5 of the March 15, 2006 Addendum to the Executive Director’s Employment Agreement.

¹⁸⁰ See MTRFA Employee Handbook updated January 2006, Section 7 (if MTRFA closes through legislation, employees receive full compensation for unused vacation days). See also May 18, 2005 MTRFA Board meeting minutes, item 8.e.ii. MTRFA staff could only carry a maximum of five vacation days into the next year. However, the Executive Director’s Employment Agreement effective July 1, 2001, Section 4.2.d. allowed the Executive Director to carry over three weeks of vacation. The Executive Director was provided with five weeks of paid vacation annually. See section 4.2.d.

- 4) \$78,773 for 185 unused sick days (75% or \$59,080 was paid to the Executive Director, and the remaining 25% or \$19,693 was deposited in the Executive Director's health care savings account);¹⁸¹
- 5) \$33,866 paid to cover the Executive Director's health insurance premiums until she is Medicare eligible;¹⁸² and
- 6) \$3,458 (consisting of a cafeteria plan contribution of \$5,640, a deferred compensation/457 retirement account payment of \$2,000, a "gross-up" of \$685 for a portion of the cafeteria plan contribution, and a subtraction of \$4,867 for a present value adjustment).¹⁸³

During our review, we found that the Executive Director did not consistently document her vacation hours. We were informed by the Controller that the Executive Director would occasionally give him a slip of paper identifying vacation days taken.¹⁸⁴ Documents provided to this Office for some of the Executive Director's vacation days contained dates covering several months. For example, one document noted the Executive Director's vacation days for 1994, 1999, 2000, and 2001. This handwritten document stated, "[h]ere are the vacation days you were missing for my records," and was signed by the Executive Director.

The Executive Director earned twelve days of paid sick leave per year.¹⁸⁵ She was paid for 185 unused sick days. This Office was informed that the Executive Director did not report taking any sick days over the course of all her years with the MTRFA.¹⁸⁶ Based upon her sick leave payout, it appears she worked more than 15 years without reporting the use of any sick leave.¹⁸⁷

Severance payments to MTRFA staff members other than the Executive Director totaled \$154,814, and sick leave costs were an additional \$26,195.75.¹⁸⁸ MTRFA staff were

¹⁸¹ See Executive Director's Employment Agreement effective July 1, 2001, Section 4.2.e. (receive 75% pay for accumulated, unused sick days). According to Section 2 of the MTRFA Employee Handbook, employees qualifying for sick leave pay at the time of separation of employment were to receive 50% in cash and 50% deposited into the employee's healthcare savings account. The MTRFA Board changed the pay-out percentages at its March 15, 2006 meeting so 25% of the sick leave pay was deposited in the employee's health care savings account. See March 15, 2006 MTRFA Board Meeting minutes, item 9.e.i.

¹⁸² See March 15, 2006 Addendum to Executive Director's Employment Agreement effective July 1, 2002, Section 5.3.2.

¹⁸³ See Executive Director's Employment Agreement effective July 1, 2001, sections 4.2.b (\$426 per month for cafeteria plan contributions), 4.2.g (deferred compensation plan contribution equal to maximum allowable by law), 5.3.3 (tax equalization or "grossed up" amount), 5.3.1 (lump sum payment reduced to present value).

¹⁸⁴ In contrast, MTRFA staff used leave slips to report their vacation days to the Executive Director. Records for staff vacation days were maintained by the Receptionist, and were recorded in MTRFA account records by the Controller.

¹⁸⁵ See Executive Director's Employment Agreement effective July 1, 2001, Section 4.2.e.

¹⁸⁶ MTRFA staff reported their sick days to the Executive Director on leave slips. Records for staff sick leave were maintained by the Receptionist, and were recorded in MTRFA account records by the Controller.

¹⁸⁷ 185 sick days/12 sick days earned per year = 15.4 years.

¹⁸⁸ For sick leave costs, 75% was paid as salary and 25% was paid to health care savings plans. The highest paid MTRFA employee, other than the MTRFA Executive Director, had a salary of \$94,144.

paid severance equal to one month of pay per year of service, capped at six months total severance. Staff were also paid for half of their accrued sick days (75% to the employee; 25% to the employee's health care savings plan). Their unused vacation days rolled over to the TRA.

B. Legal Fees

Total legal fees for fiscal year 2006 were \$161,987. In fiscal years 2005 and 2004, legal fees were \$12,545 and \$35,731 respectively. In fiscal year 2005, \$11,585 was paid to Robert Butterbrodt, who had been the MTRFA's attorney for many years. His work included general pension issues, individual pensioner issues, audit responses and miscellaneous other issues. In fiscal year 2005, no legal fees were paid for investment related work, and \$960 was paid to Moss & Barnett for real estate related work.

Much of the increase in legal fees in fiscal year 2006 is attributable to the Liquidating Trust. We found legal fees were billed for work performed by Mr. Butterbrodt on a memorandum opinion regarding a "reserve account for contractual obligations" as early as March 15, 2006.

Between May 26, 2006 (when the Liquidating Trust was funded), and June 30, 2006, Moss & Barnett was paid \$95,396.34, Mr. Butterbrodt was paid \$27,286.54, and Fredrikson & Byron was paid \$13,167.50.¹⁸⁹ Thus, in just over one month, the legal fees paid by the MTRFA were \$135,850.38, more than ten times the legal fees for all of fiscal year 2005. The MTRFA did not pay the legal fees of Best & Flanagan relating to the Liquidating Trust.¹⁹⁰ Instead, those fees were submitted, and will continue to be submitted, directly to the Liquidating Trust.

C. Insurance

Insurance costs nearly tripled in fiscal year 2006. Insurance costs were \$64,443 in fiscal year 2005, and rose to \$182,232 in fiscal year 2006. This increase is primarily attributable to the "Fiduciary Liability Insurance Six-Year Tail Coverage" that cost \$118,996, and was effective on June 30, 2006, for six years.

Prior to purchasing the six-year tail coverage, the MTRFA paid \$59,498 for a one-year Fiduciary Liability policy that was effective April 6, 2006, and expired April 6, 2007. The one-year policy was replaced by the six-year tail coverage.

D. Other Increases

Business expenses almost doubled in fiscal year 2006, increasing from \$11,357 in fiscal year 2005 to \$20,327 in fiscal year 2006. The increase is unrelated to the consolidation. Rather, the increase was primarily due to a large number of disability examinations. We

¹⁸⁹ The work by Fredrikson & Byron involved a determination of indemnification obligations.

¹⁹⁰ MTRFA paid Best & Flanagan \$2,136.50 on December 6, 2005 for legal work regarding a defamation issue.

also noted that business expenses fluctuated widely in past years, and therefore the increase in fiscal year 2006 was not unusual.

During our review of the MTRFA's administrative expenses, we found three checks reimbursing the Executive Director for one-half of her cellular telephone charges. The three checks, dated April 28, 2006, May 19, 2006, and June 21, 2006, reimbursed the Executive Director for \$826.82 in cellular telephone charges. The employee reimbursement request forms and documents supporting the April 2006 check included reimbursement requests for cellular telephone calls dating back to July 16, 2003.¹⁹¹ Summary invoices were submitted as support for the cellular telephone charges, and no detailed cellular telephone bills were attached to the reimbursement request forms.¹⁹²

Audit fees increased from \$19,048 in fiscal year 2005 to \$35,999 in fiscal year 2006. \$10,000 of this increase was for Financial Advisors, LLC, to create estimates for amounts to transfer to the Liquidating Trust. The remaining audit fees in fiscal year 2006 were paid to the State Auditor's Office.¹⁹³

Conclusions

- MTRFA salaries and employee benefits increased \$455,133 from fiscal year 2005 to fiscal year 2006. Most of the increase came in the form of severance packages triggered by the MTRFA's consolidation with the TRA.
- The MTRFA Executive Director's final compensation and benefits package cost \$357,385.
- Total legal fees for fiscal year 2006 were \$161,987, up from \$12,545 in fiscal year 2005. Much of the increase is attributable to the Liquidating Trust.
- Between May 26, 2006, and June 30, 2006, the MTRFA paid attorneys \$135,850.38, more than ten times the total legal fees paid in fiscal year 2005.
- The MTRFA purchased a "Fiduciary Liability Insurance Six-Year Tail Coverage" policy for \$118,996.
- Increases in business expenses were not related to the consolidation.

¹⁹¹ The payment was for cellular telephone calls dated from July 16, 2003 through November 15, 2003 and February 4, 2005 through March 31, 2006. The Internal Revenue Service requires employee business expenses to be submitted for reimbursement within 60 days after the expense is incurred. If not submitted within 60 days, the reimbursement becomes taxable. The April 28, 2006 check was not reduced for any taxes. The May and June checks were for cellular telephone charges incurred in April and May 2006, respectively.

¹⁹² MTRFA's Governance Manual Sections 3 and 13 state that staff and the board will be reimbursed for ordinary and necessary expenses actually incurred in the conduct of business. Without detailed billings, it cannot be determined if the expenses were actually incurred in the conduct of business.

¹⁹³ The increase in the State Auditor's billings was primarily due to extra time spent assisting with the implementation of a new GASB Statement and increased billing rates.

XII. TRANSFER OF INVESTED ASSETS AND FIXED ASSETS AND EQUIPMENT

The State Auditor's Office was asked to evaluate compliance with the requirement that the entire assets of the MTRFA be transferred to the TRA. Historically, the assets of the MTRFA have consisted of cash and investments, receivables, and fixed assets. Receivables, for the most part, were not evaluated for the purpose of this special review.

Cash and investments accounted for nearly all of the assets of the MTRFA. We reviewed reports provided by both Mellon Trust (MTRFA's custodian) and reports prepared by the State Board of Investment (SBI), investing on behalf of the TRA, in conjunction with State Street (SBI's custodian). These reports are in agreement showing the following transfers of assets in cash:

June 21, 2006	\$705,821,005
June 23, 2006	773,692
June 29, 2006	1,271,921
Total	\$707,866,618

The MTRFA's \$13,929,724 cost basis of investments in venture capital also transferred to SBI on June 21, 2006. Cash transfers to SBI for investment-related receivables occurred in July 2006 totaling \$975,862. Closing of the MTRFA's Wells Fargo checking account was overseen by TRA staff. In addition to this total \$722,772,204 already transferred, SBI has indicated they still expect to receive some small amounts related to the consolidation.

Based on a review of the MTRFA's general ledger, there is no indication of the existence of any additional accounts that should have been transferred or otherwise accounted for in compliance with the Consolidation Legislation except the Liquidating Trust. As noted previously, the TRA has not received over \$1.5 million in assets that the MTRFA diverted out of its Special Retirement Fund and into the Liquidating Trust prior to consolidation.

Staff from the TRA was onsite and actively monitoring the activities of the MTRFA during the last weeks of June. This included taking possession of the fixed assets and equipment. The June 30, 2005, audited financial statements identify furniture and fixtures with a cost value of \$296,948 and depreciated value of \$18,937. The TRA determined which items to keep, and the remaining items were surplus. We are not aware of any issues regarding the transfer of fixed assets other than that of the laptop computer hard drive discussed earlier in this report.

Conclusion

- Aside from the money diverted into the Liquidating Trust, it appears that the assets of the MTRFA Special Retirement Fund have been transferred to the TRA.

XIII. CONCLUSION

Pursuant to the TRA's request, the State Auditor's Office reviewed several areas of legal compliance. This Special Review Report set out areas in which we find the MTRFA violated Minnesota law. By far the most egregious act was the taking of \$1.5 million from the MTRFA Special Retirement Fund for the benefit of the former MTRFA Board members and Executive Director. Other legal violations include the taking or erasure of the Executive Director's laptop computer hard drive and the MTRFA's \$118,996 expenditure for insurance without TRA approval after enactment of the Consolidation Legislation.

The fiduciaries of the MTRFA had an affirmative duty to the State of Minnesota, as well as the other beneficiaries of its pension plan, to act in utmost good faith in accordance with state law, and not in "bad faith" in order to advance their own self-interests.

It is our conclusion that the MTRFA fiduciaries violated this standard of conduct in various respects, but especially in the creation and funding of the Liquidating Trust. These actions by the MTRFA fiduciaries go beyond failing to act in good faith and constitute a deliberate violation of state law they had a duty to follow. These actions were done for the purpose of advancing their own personal interests. Now, the State of Minnesota, to whom they owed a duty of loyalty and good faith, is being coerced into indemnifying them for their bad faith actions as plan fiduciaries.

With regard to their liability, fiduciaries that commit a breach of trust are liable for loss of value in the trust amount that results from their breach.¹⁹⁴ This means that in addition to the over \$78,000 in attorney bills already charged to the Liquidating Trust, the MTRFA fiduciaries may be liable for losing investment returns because the monies in the Liquidating Trust are being held in a bank account with a low rate of return and are not being invested with the rest of the pension fund assets.

As a successor trustee, the TRA is not liable for the bad faith, self-dealing actions of the MFTRA Board and Executive Director.¹⁹⁵ However, being knowledgeable of the breaches of fiduciary duty by its predecessor places certain fiduciary obligations on the TRA. The Restatement (Second) of Trusts lists these duties as follows:

- A trustee is liable to the beneficiary for a breach of trust, if he
- (a) knows or should know of a situation constituting a breach of trust committed by his predecessor and he improperly permits it to continue; or
 - (b) neglects to take proper steps to compel the predecessor to deliver the trust property to him; or

¹⁹⁴ Restatement (Second) of Trusts § 205 (1959).

¹⁹⁵ Restatement (Second) of Trusts § 223 (1959).

(c) neglects to take proper steps to redress a breach of trust committed by the predecessor.¹⁹⁶

The TRA has already acted in several ways to redress some of the problems it inherited as successor in interest to the MTRFA. For example, the TRA diligently attempted to recover information from the taken laptop computer hard drive by insisting that it be returned and by hiring two consultants in an attempt to recover data from the hard drive returned by the Executive Director. The TRA also acted to retrieve private data on members that had been withheld by the Executive Director and the MTRFA's attorney. The TRA requested the return of the \$1.5 million the MTRFA diverted to the Liquidating Trust. After the Liquidating Trustee sued it, the TRA also instituted counterclaims that may result in the recovery of this money, so it can be used to benefit retired teachers.

The State Auditor's Office suggests that the TRA, as successor trustees, address issues brought forward in this Special Review Report. We also recommend that the TRA confer with its legal counsel to determine whether any additional action may be warranted to obtain the funds being held illegally in the Liquidating Trust. In determining how to proceed, the paramount consideration should be the health of the pension fund and whether any action or inaction by the TRA benefits the members of the TRA.

Because this Special Review Report discloses malfeasance, misfeasance, or nonfeasance, it will be filed with the Hennepin County Attorney for the institution of such civil and criminal proceedings as the law and the protection of the public interests shall require.¹⁹⁷

¹⁹⁶ *Id.*

¹⁹⁷ *See, e.g.*, Minn. Stat. § 6.48-.51.

This page was left blank intentionally.



PATRICIA ANDERSON
STATE AUDITOR

STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

MINNEAPOLIS TEACHERS' RETIREMENT FUND ASSOCIATION SPECIAL REVIEW REPORT

October 3, 2006

CHRONOLOGY APPENDIX

2004

2004 Legislative Session

Rep. Jim Knoblach, Chair of the Ways and Means Committee in the House of Representatives, inserted into the omnibus State Government Finance bill (HF2684) various measures designed to improve the funding status of MTRFA. Concerned with lackluster investment performance, Rep. Knoblach sought to encourage MTRFA to invest with the State Board of Investment (SBI) by imposing a charge on the Fund's beneficiaries equal to any amount that MTRFA's holdings underperformed SBI. Rep. Knoblach also sought to suspend statutory performance-based annuity increases for beneficiaries unless and until the overall Fund achieved 100 percent funding status. The provisions did not become law.

April 27, 2004 - MTRFA's Investment Advisory Committee (IAC) Meeting

MTRFA's Executive Director outlined one of MTRFA's legislative priorities to be removal of the Knoblach sections from the State Government Finance bill. The meeting minutes summarized the provisions as being "detrimental to MTRFA members and [not solving] the MTRFA's funding problem."¹

November 9, 2004 - MTRFA's IAC Meeting

The Executive Director of SBI, Howard Bicker, who was a member of the IAC, recommended that MTRFA have legislation drafted to alter the Fund's statutory post-retirement adjustments.² This recommendation was one of the two principal reforms that had been proposed by Rep. Knoblach.

¹ Investment Advisory Committee meeting minutes – April 27, 2004

² Investment Advisory Committee meeting minutes – November 27, 2004: "Howard Bicker recommended that the MTRFA draft legislation that will change the post retirement adjustment due to the MTRFA's negative cash flow and the strain it places on the fund."

2005

2005 Legislative Session

Companion bills SF1519 and HF1615 were introduced in the Minnesota Senate and House of Representatives respectively. This early incarnation of the Consolidation Legislation called for MTRFA coordinated members to become members of the Teachers Retirement Association (TRA) on July 1, 2005, and set a December 31, 2005 date for the transfer of assets from MTRFA to TRA. The proposal made a distinction between the MTRFA coordinated and basic plans, with TRA assuming various duties under the proposal as of January 1, 2006, and MTRFA having until December 31, 2006 to transfer to TRA “all records and documents relating to the funds and the benefit plans of the association...”³ The legislation did not eliminate MTRFA, and anticipated ongoing duties for the MTRFA Board with respect to the basic fund members. Neither SF1519 nor HF1615 were formally acted upon by the committees where they were sent.

January 19, 2005 – MTRFA Board Meeting

The MTRFA Board was briefed on the legislative consolidation proposal that called for the MTRFA coordinated members to be transferred to TRA, and MTRFA to exist only to oversee a closed fund for its basic members. The MTRFA Board voted unanimously to support the proposal.⁴

January 31, 2005 – MTRFA’s IAC Meeting

MTRFA’s Executive Director reviewed the rationale behind the 2005 legislative language that would provide a partial consolidation of coordinated members with TRA, and “guarantee the benefit payments of the Basic Members in a closed fund at MTRFA.” The Committee was also informed that MTRFA would transfer \$10 million on January 31, and \$8 million on February 1, to the cash account to fund upcoming monthly annuity payments.⁵

March 16, 2005 – MTRFA Board Meeting

The MTRFA Board was informed that MTRFA scheduled a liquidation of \$18 million in cash in March 2005 to cover annuity payments for the months of April and May 2005.⁶

April 20, 2005 – MTRFA Board Meeting

MTRFA’s Executive Director discussed that Rep. Knoblach had re-introduced his MTRFA reform provisions during the 2005 legislative session. According to the meeting’s minutes, “Without additional funding, which this bill does not provide, pensions of MTRFA members will continue to be in jeopardy.”⁷

³ See HF1615 as introduced March 7, 2005.

⁴ MTRFA Board of Trustees meeting minutes – January 19, 2005.

⁵ Investment Advisory Committee meeting minutes – January 31, 2005

⁶ MTRFA Board of Trustees meeting minutes – March 16, 2005.

⁷ MTRFA Board of Trustees meeting minutes – April 20, 2005.

May 16, 2005 – Senate Finance Committee (SF1057)

In the closing days of the legislative session, the Senate Finance Committee transformed a short retirement bill, SF1057, into a 96-page omnibus pension bill. The consolidation provisions of the new omnibus pension bill differed substantially from the text of SF1519/HF1615 in several key ways. The new bill provided that all assets, records and members of MTRFA were to be transferred to TRA *on the day following enactment of the legislation.*⁸ The new legislation included a section entitled “Termination of the Minneapolis Teachers Retirement Fund Association” which called for MTRFA to cease to exist as a Minnesota public pension plan “[a]s of the effective date of this section and upon the transfer of administration, records, assets, and liabilities from the [MTRFA] to [TRA]...”⁹

May 18, 2005 – MTRFA Board Meeting

The MTRFA Board noted that SF1057 would consolidate MTRFA with TRA the day after enactment. MTRFA’s counsel identified concerns with the legislation. The MTRFA Board went into executive session “to discuss administrative items.” After the executive session, by unanimous roll call vote, the MTRFA Board voted to set aside an escrow account “to cover expenses, contract obligations, indemnification of employees and indemnification of fiduciaries.”¹⁰ The MTRFA Board then voted to provide employees with “full compensation for vacation days” if MTRFA “closes through [the] pending legislation.”¹¹

May 19, 2005 – The Minnesota Senate

The Minnesota Senate passed SF1057. The Minnesota House of Representatives did not take action on SF1057 during 2005 but was poised to take it up in the 2006 session.¹²

June 13, 2005 – Email from TRA Assistant Executive Director to MTRFA Executive Director

TRA noted that indemnification language in SF 29 1st Special Session may be overly broad and not needed, given the bill’s language that TRA was “the successor of interest for all claims for and against the special retirement fund and [TRA] may assert any applicable defense the MTRFA would have been entitled to assert relating to the special retirement fund.” TRA also requested that MTRFA provide TRA with a list of “contract liabilities and obligation of MTRFA that would be fully enforceable liabilities and obligations of TRA.”¹³

June 14, 2005 – Letter from MTRFA Attorney to MTRFA Executive Director

MTRFA received a letter from MTRFA Attorney Butterbrodt regarding the establishment of a general fund as a subfund of MTRFA’s special retirement fund for the purpose of

⁸ See SF1057 2nd Engrossment, May 17, 2005. *Emphasis added.*

⁹ SF1057 2nd Engrossment, art. 2, § 9, subd. 7, May 17, 2005.

¹⁰ MTRFA Board of Trustees meeting minutes – May 18, 2005. At its meeting on June 15, 2005, the MTRFA Board adopted a formal resolution concerning the escrow account.

¹¹ MTRFA Board of Trustees meeting minutes – May 18, 2005.

¹² An omnibus pension bill, containing consolidation provisions, was also introduced during the 2005 special legislative session. See SF29, 1st Special Session (2005).

¹³ June 13, 2005 Email from Luther Thompson to Executive Director Kilberg.

paying MTRFA's legal obligations "until such time as it is fully consolidated into TRA and ceases to function as a public pension fund." According to the letter, the subfund would not be transferred to the State with the assets of the special retirement fund as part of the funding consolidation. A proposed draft resolution was attached for consideration by the MTRFA Board.¹⁴

June 15, 2005 – MTRFA Board Meeting

The MTRFA Board went into executive session "to discuss legal and employee issues." After the executive session, the MTRFA Board approved salary increases for two employees, agreed that any separation benefits for future health care or medical insurance cost should be deposited in the employee's health care savings plan account, and replaced the May 18, 2005, Board motion regarding an escrow account with the resolution provided by Attorney Butterbrodt.¹⁵

The resolution regarding the escrow account had the following "whereas" clauses: 1) the Minnesota Legislature expects to enact legislation to consolidate MTRFA and TRA, and to transfer the assets of the special retirement fund to the State, causing MTRFA to cease to function as a Minnesota public pension plan; 2) MTRFA would "continue to exist as a non-profit corporation with general tax-exempt purposes after said Consolidation"; and 3) "MTRFA desires to make provision for legal debts, obligations and expenses related to its function as a Minnesota public pension plan that exist and will continue after said Consolidation." The resolution then established "a separate, related expense operating account" to hold funds to pay the legal debts, obligations and expenses mentioned in the third "whereas" clause. The resolution also provided that the separate account "shall not be subject to transfer to the State of Minnesota with other assets to be transferred as part of said Consolidation." Finally, the resolution authorized the Executive Director or other Board designee to identify the "known and anticipated legal debts, obligations and expenses of MTRFA, other than retirement annuities and benefits after said Consolidation", and to deposit, keep, disburse and account for the funds in the separate account, as the Board deemed "reasonable and advisable in the circumstances."¹⁶

At this meeting, the MTRFA's Executive Director also reported to the MTRFA Board that \$16 million would be transferred out of the equity sector into the cash account to make the July 1 monthly annuity payments.¹⁷

August 12, 2005 – State Auditor Speech to Minneapolis Downtown Rotary Club

State Auditor Anderson discussed problems with MTRFA and other Minneapolis pension plans. The State Auditor stated that it was unacceptable to allow a major local pension plan to fail, and called for the State to step forward with a workable solution.¹⁸

¹⁴ June 14, 2005 Letter from Attorney Butterbrodt to MTRFA Executive Director Kilberg.

¹⁵ MTRFA Board of Trustees meeting minutes – June 15, 2005.

¹⁶ Resolution attached to the MTRFA Board of Trustees meeting minutes – June 15, 2005.

¹⁷ MTRFA Board of Trustees meeting minutes – June 15, 2005.

¹⁸ The speech is available on the State Auditor's website at:

<http://www.osa.state.mn.us/default.aspx?page=MplsPensionPlansSpeech>.

August 22, 2005 – State Auditor Article in Minneapolis Star Tribune on Minneapolis Pensions

State Auditor Anderson called for permanent funding and administrative solutions for four Minneapolis pension plans, including MTRFA. She noted that the failure to consolidate these plans into statewide systems resulted in the present painful funding crisis.¹⁹

August 24, 2005 – MTRFA’s IAC Meeting

The IAC meeting minutes noted that MTRFA staff had been “liquidating assets more frequently (six of the last eight months during calendar 2005) to cover the monthly annuity payments for Minneapolis Teachers. As of December 31, 2005, the MTRFA has projected a \$76 million negative cash flow for the year.”²⁰ The IAC was “asked to advise the board of trustees on the most cost effective way to invest the assets so that the board can provide future cash flow responsibilities.” The IAC recommended liquidating the actively managed domestic equity assets and placing the assets in index funds, so cash could be raised in a more cost effective manner, and criticism of the MTRFA’s equity performance would be eliminated.²¹

September 15, 2005 – Letter from MTRFA Attorney to MTRFA Executive Director

MTRFA was advised it would be difficult to maintain a defamation action with respect to statements charging MTRFA with “financial mismanagement by the fiduciaries” and statements suggesting that MTRFA’s assets “have been mismanaged.”²²

November 10, 2005 - Letter from MTRFA Attorney to MTRFA Executive Director

MTRFA’s attorney provided MTRFA’s Executive Director with a list of possible workshop topics relating to the role of MTRFA after the retirement fund was rolled into TRA. Among other issues, the letter asked if MTRFA had a mission after the Fund itself was transferred to the State; it questioned whether MTRFA’s tax exempt status as a “teachers’ retirement fund association of a purely local character” would apply when the Fund had been transferred; and it asked how much member dues should be if they became the only source of financial support for MTRFA.²³

November 16, 2005 – MTRFA Board Meeting

The MTRFA Board approved implementation of the IAC’s recommendation to liquidate the four active domestic equity portfolios, and invest them in “an enhanced stock index fund.”²⁴ The stated purposes were so that cash could be raised in a more cost effective manner and criticism eliminated of the MTRFA’s equity performance.

¹⁹ The article is available on the State Auditor’s website at:

http://www.osa.state.mn.us/other/PublishedArticles/mplsPensions_article.pdf.

²⁰ Investment Advisory Committee meeting minutes – August 24, 2005

²¹ *Id.*

²² September 15, 2005 Letter from Attorney Barnard, of the law firm of Best & Flanagan, to MTRFA Executive Director Kilberg.

²³ November 10, 2005 Letter from Attorney Butterbrodt to MTRFA Executive Director Kilberg.

²⁴ MTRFA Board of Trustees meeting minutes – November 16, 2005.

November 28, 2005 – MTRFA’s Actuarial Valuation and Review as of July 1, 2005

An Actuarial Valuation and Review as of July 1, 2005 was submitted to MTRFA by The Segal Company. The Review expressed “continued serious concerns about the financial health of this plan. Absent a significant financial solution, we are concerned about the ability of this plan to make its benefit promises.” According to the Review, “[t]he plan remains in serious financial trouble.” The Review found MTRFA’s unfunded actuarial accrued liability was \$972.6 million.

December 6, 2005 – MTRFA’s IAC Meeting

This is the last meeting held by the IAC.

2006

January 24, 2006 – State Auditor’s MTRFA Audit Report for the Year Ended June 30, 2005

The State Auditor sent to MTRFA a copy of the Office of the State Auditor’s audit report for MTRFA for the year ended June 30, 2005. The report stated:

[A]s a result of [MTRFA’s] current and deteriorating financial condition, it is questionable just how far into the future [MTRFA] will continue to be a going concern. . . . Clearly, under continued conditions such as this, a failure to make benefit payments as they become due is inevitable.²⁵

The State Auditor’s report noted that between 2000 and 2005, net assets available for pension benefits had decreased by \$354.3 million or 32 percent. The report noted that MTRFA’s unfunded actuarial accrued liability had increased 88 percent since June 30, 2000, and the funded ratio had fallen from 66.54 percent to 44.61 percent. The State Auditor’s report noted that current law did not provide a safety net for this pension fund, cited Minn. Stat. § 354A.09 requiring pro-rating of benefits when the fund’s assets were not sufficient to pay annuities and other retirement benefits in full, and reminded MTRFA there was no promise by the legislature to make MTRFA actuarially sound.²⁶ The report concluded:

[MTRFA] is in a position where it will be unable to make benefit payments at some point in the foreseeable future. Regardless of the history behind [MTRFA’s] funding status and benefit levels, the current financial condition of this fund puts [MTRFA] in a position where it must concede to changes. The [MTRFA’s] primary fiduciary responsibility is to immediately develop a viable plan to improve its current financial condition. Consistent with this, we recommend [MTRFA] initiate and actively pursue all courses of legislative action. This should include consolidation with [TRA] as a permanent solution. It should also include alternatives for restructuring or capping benefit amounts and formulas. While these alternatives may be small scale or temporary when

²⁵ Office of the State Auditor, MTRFA Audit Report for the Year Ended June 30, 2005, pp. 32-33.

²⁶ *Id.* at p. 33.

compared to consolidation, they must be considered as an option since consolidation is not guaranteed.²⁷

January 25, 2006 – Letter from Auditor Anderson to Governor Pawlenty

The State Auditor sent a copy of the MTRFA audit report to Governor Pawlenty, drawing particular attention to the report’s comments relating to the financial condition of MTRFA.

March 1, 2006 – 2006 Legislative Session

Several of the legislators who had authored HF1615 in 2005 introduced HF2847. The bill did not have a Senate companion since the Senate had passed a consolidation initiative in 2005 (SF1057).

HF2847 had many differences from both SF1057 and the House proposal from the previous year. The bill once again provided a phased schedule for consolidation, with the membership of MTRFA transferring to TRA on July 1, 2006, and a requirement that all assets transfer by the previous day, June 30, 2006.²⁸ MTRFA was given an additional year, until June 30, 2007, to transfer its records to TRA.²⁹ The legislation did not terminate MTRFA itself, but stated that the *special retirement fund* of MTRFA would “[cease] to exist as a legal entity and public pension plan... as of December 31, 2007, and upon the transfer of administration, records, assets, and liabilities” to TRA.³⁰

HF2847 provided an intricate framework whereby MTRFA could, with the permission of its (presumably, former) members retain a general fund if it found that it had general fund assets on December 31, 2007.³¹ If it did not have such assets on December 31, 2007, the MTRFA Board was authorized to create a general fund if it so chose “which may conduct business on behalf of the Minneapolis Teachers Retirement Fund Association as the board of the Minneapolis Teachers Retirement Fund Association may direct.”³² The section called upon MTRFA to pay the costs incurred as a result of consolidation from MTRFA’s special retirement fund, and required the State Board of Investment (SBI) to release certified amounts to the MTRFA Board for payment of any consolidation expenses incurred after the date the special fund assets were transferred to TRA but before the “termination of the pension plan.” SBI was also directed to release amounts to MTRFA on a monthly basis to pay the “actual, reasonable, and necessary administrative expenses of the retirement office”, and the legislation made an extensive, but not exclusive, delineation of what those costs might entail.³³ These administrative expenses ranged from salaries for the executive director and office staff, to “postage” and “periodical subscriptions”, and concluded with the stock catch-all of any other “actual, reasonable, and necessary expenses” authorized by the MTRFA Board. In contradiction

²⁷ *Id.*

²⁸ See HF2847 as introduced March 1, 2006.

²⁹ *Id.*

³⁰ *Id.* at § 8, subd. 7.

³¹ The State Auditor’s Office has audited MTRFA for several years. We are unaware of any MTRFA “general fund.”

³² HF2847 as introduced, § 8, subd. 7 (a).

³³ *Id.* at subd. 7 (b).

to this continued authority for the MTRFA Board to incur expenses, the bill made clear that TRA was specifically liable for any and all “contract liabilities and obligations” of the special fund existing at the time of consolidation or at the time of the special fund’s termination.³⁴

March 6, 2006 – Letter from State Auditor to MTRFA Executive Director

Noting that pending legislation called for TRA to assume all “contract liabilities and obligations” of MTRFA, the State Auditor requested copies of all MTRFA contracts that created liability or obligations on the part of MTRFA.

March 15, 2006 – Letter from MTRFA’s Attorney to MTRFA Executive Director

MTRFA Attorney Butterbrodt provided MTRFA’s Executive Director a letter confirming their prior discussions:

We have discussed the idea of a reserve account to hold funds for paying the contractual obligations of the MTRFA that are related to its staff employees and to hold such an account back from transfer to the state in the anticipated consolidation. The motivation for holding such an account back would be to guarantee payment of the contractual obligations to staff and thereby avoid the risk that such obligations would not be honored by the state.³⁵

The letter noted:

There may be an argument about whether or not this authority permits the MTRFA to segregate the funds in such an account from the assets mandated for transfer to the state in the consolidation. You have already indicated that contractual obligations of the MTRFA may be under scrutiny. Holding back a reserve for employee obligations may also come under scrutiny.³⁶

March 15, 2006 – MTRFA Board Meeting

After an executive session “to discuss personnel issues,” the MTRFA Board approved payout of sick leave upon separation so that 25% would be deposited in the employee’s health care savings account, increased the salary for one employee, and “continue[d] the employment contract” of MTRFA’s Executive Director until June 30, 2007. The minutes did not reference the advice received from Attorney Butterbrodt regarding “a reserve account.”³⁷

³⁴ *Id.* at subd. 7 (c).

³⁵ March 15, 2006 Letter from Attorney Butterbrodt to MTRFA Executive Director Kilberg.

³⁶ *Id.*

³⁷ MTRFA Board of Trustees meeting minutes – March 15, 2006.

March 16, 2006 – House of Representatives, Government Operations and Veterans Affairs Committee (Hearing of Consolidation Legislation, HF2847)

No MTRFA employee or board member testified at the hearing.³⁸ Both Luther Thompson and Laurie Hacking testified on behalf of TRA. One representative each from Education Minnesota and from the Minnesota Principals Association also testified in support of the Consolidation Legislation.³⁹

March 22, 2006 – House of Representatives, Education Finance Committee (Hearing of Consolidation Legislation, HF2847)

No MTRFA employee or board member testified. Luther Thompson of TRA, Larry Martin of the Legislative Commission on Pensions and Retirement, and Howard Bicker of SBI provided details of the consolidation proposal. As part of an introduction and overview of the legislation, Rep. Dennis Ozment said, “We certainly don’t want a pension fund to go bankrupt” and advised that the legislature should take advantage of TRA’s “willingness to help us” [by absorbing MTRFA into TRA].⁴⁰

March 22, 2006 – Office of the State Auditor

In reviewing the documents requested from MTRFA in the March 6, 2006 letter, the Office of the State Auditor learned that, on March 15, 2006, the MTRFA Board had amended and extended the employment contract of MTRFA’s Executive Director.

April 11, 2006 – House of Representatives, State Government Finance Committee (Hearing of Consolidation Legislation, HF2847)

State Auditor Pat Anderson testified to express disapproval over the March 15, 2006 actions of the MTRFA Board in extending the contract of the MTRFA Executive Director and granting her a severance package triggered by consolidation. Auditor Anderson encouraged adoption of an amendment to eliminate the year-long period for the transfer of documents after the transfer of members and assets to TRA on July 1, 2006 and June 30, 2006, respectively. The amendment also made the MTRFA personnel, with the exception of the Executive Director, employees of TRA in order to aid in the consolidation. As a result, there was no need for MTRFA’s continued existence into 2007 for the transfer of records. Auditor Anderson stressed that a key component of the amendment prohibited the MTRFA Board from entering any contractual obligations without the express permission of TRA between the date of the legislation’s enactment and June 30, 2006.⁴¹

³⁸ During our review of MTRFA’s 2006 Board of Trustee meeting minutes, we found no formal endorsement by the MTRFA Board concerning the 2006 Consolidation Legislation. The Executive Director of MTRFA did not testify before any House of Representatives committee considering the consolidation bill in 2006 for the purposes of advocating for its passage.

³⁹ Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=12&ls_year=84.

⁴⁰ Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=8&ls_year=84.

⁴¹ Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=22&ls_year=84.

MTRFA's Executive Director testified that nothing untoward occurred in the extension of her contract. She testified that her contract was extended because it was set to expire on June 30, 2006, and she would have been "out looking for a new position" because she "can't afford to not have a paycheck." She stated that the MTRFA Board anticipated a continued need for her services at the time they extended and modified her contract because the legislation, without the amendment being considered, called for MTRFA to exist until 2007.

Larry Risser, a trustee and the Treasurer of the MTRFA Board, testified in support of the Executive Director's reputation and competence, and in support of the MTRFA Board's action in extending her contract and awarding the severance. He testified in opposition to the amendment the committee was considering, particularly the timeframe that called for MTRFA's dissolution on June 30, 2006:

If we are concerned about doing due diligence and doing things correctly, I hope that we won't cram the process that requires months into a matter of weeks. Trustees as fiduciaries have a personal stake in the credibility of this transfer. You probably want an exit audit to be completed as the assets are transferred. I would hope that you would listen to the people who have direct experience in this... Laurie Hacking [of TRA], [MTRFA Executive Director] Karen [Kilberg], Howard Bicker [of SBI]... the people who are familiar with the complexity of the task rather than opting for a simple solution that can be crammed through and accepted in really a dangerous, short-term format.

Larry Risser, MTRFA Trustee

Mr. Risser defended the overall management of the fund and decried past funding shortfalls. When asked to explain the financial problems of MTRFA if it were a well-managed fund, he placed part of the blame on statutory requirements to pay out investment profits rather than reinvest them. That response prompted the following exchange:

Where was the effort to change the statute so that you weren't paying out huge benefit increases while the fund wasn't making its returns?

Rep. Phil Krinkie (to Mr. Risser)

I don't believe that we lobbied for that. I can't give you the exact history but when you start off with a fund that's maybe 60% funded and then [market increases] lock in the obligation, you have a real problem... We would have been fine [paying the statutory increases] if we had been 100% funded from the start.

Larry Risser, MTRFA Trustee

Mr. Risser further stated that MTRFA would not have been in financial difficulty if it had received an infusion of public money on par with what TRA had received in the past.

There was no additional testimony regarding the proposed amendment. Laurie Hacking and Luther Thompson of TRA, as well as Howard Bicker of SBI, were present throughout the discussion and did not express any misgivings about its provisions, including the expedited timetable imposed on TRA and SBI. All three individuals readily testified later in the hearing to an unrelated portion of the bill.

Just before the committee voted on the amendment, Auditor Anderson urged its adoption and reiterated the key provision, that upon enactment of the legislation, the MTRFA Board could not enter any contracts without TRA's permission:

From the time you pass this... let's say you pass it next month... the [MTRFA] Board can't enter into any more contracts. There will be no more surprises.

State Auditor Pat Anderson

The committee adopted the amendment.

April 11, 2006 - State Auditor Press Release

In addition to providing testimony to the State Government Finance Committee, the State Auditor issued a press release entitled "State Auditor Pat Anderson Outraged by New Contract for Minneapolis Teachers Pension Executive Director," and subtitled "Yet Another Reason Why Merger with TRA Needs to Take Place ASAP."⁴²

April 18, 2006 – Letter from the State Auditor to MTRFA President Downing

The State Auditor asked MTRFA for information about the Executive Director's contract extension and severance package.⁴³

April 19, 2006 – MTRFA Board Meeting

The MTRFA Board was informed at this meeting that staff would be withdrawing \$10 million in cash out of an active enhanced index fund to pay the May 1, 2006 annuity payments.⁴⁴

A representative of the State Auditor's Office was asked to leave the meeting because the Board was going into closed "executive session" to discuss "merger issues" and "staffing issues" with attorneys Butterbrodt and Lazarus. Following the closed executive session, the minutes stated that the MTRFA Board decided to make their "best effort" to respond to the State Auditor's April 18, 2006 letter.⁴⁵

The minutes of the April 19, 2006, regular meeting of the MTRFA Board make no reference to the Liquidating Trust, a reserve account, or an escrow account.⁴⁶

⁴² The press release is available at the State Auditor's web site:

<http://www.auditor.state.mn.us/default.aspx?type=prs>.

⁴³ April 18, 2006 Letter from State Auditor Anderson to MTRFA President Downing.

⁴⁴ MTRFA Board of Trustees meeting minutes – April 19, 2006.

⁴⁵ *Id.*; also State Auditor's Office staff interview.

⁴⁶ The MTRFA voted to create the Liquidating Trust at its May 8, 2006 special meeting.

April 19, 2006 – Letter from the State Auditor’s Office to MTRFA President Downing

The representative of the State Auditor’s Office asked to leave MTRFA’s April 19, 2006 meeting wrote MTRFA explaining why he believed the MTRFA had violated the Minnesota Open Meeting Law by closing the April 18, 2006, meeting.⁴⁷

April 23, 2005 – Email From MTRFA Executive Director to TRA Executive Director

In an email, the MTRFA Executive Director provided the TRA Executive Director with “a list of some of the issues that the MTRFA is concerned about.” In a two-page document entitled “Critical Time Sensitive Issues for MTRFA Merger with TRA”, the MTRFA Executive Director raised concerns about the July 1, 2006 annuity payroll, MTRFA’s fiscal year 2006 taxes, the ability of current MTRFA fiduciaries to verify the transfer of assets to TRA, and other issues. Among other questions, the document asked TRA who would take on the liability if the asset transfer did not go smoothly, and whether TRA would honor MTRFA’s existing contracts. The document stated that it assumed MTRFA would be merged with TRA on June 30, 2006.

April 25, 2006 – Letter from MTRFA Board President to the State Auditor

The President of the MTRFA called the State Auditor’s statements “inflammatory and accusatory charges.”⁴⁸ In defense of closing the April 19, 2006 meeting, the letter claimed it was reasonable to view the State Auditor’s statements and the questions raised by the State Auditor in her April 18, 2006 letter “as pending or threatened litigation to be instituted by the State Auditor.”⁴⁹ The letter provided information regarding the Executive Director’s contract and explained the closing of the April 19, 2006 meeting.

May 2, 2006 – Letter from TRA Executive Director to MTRFA Executive Director

TRA’s Executive Director sent a six-page letter to MTRFA’s Executive Director attempting to address the issues raised by MTRFA’s Executive Director about the consolidation. Among other things, the letter affirmatively stated that MTRFA could make payments on obligations “contractually established or their budget approved prior to enactment of the bill”; TRA would be responsible for all of the expenses of MTRFA billed or received after consolidation; TRA would assume responsibility for the filing of necessary MTRFA Internal Revenue tax reporting forms; and TRA would indemnify MTRFA Board members for all good faith actions per the proposed legislation. To insure “the seamless continuation of monthly payments to MTRFA benefit recipients”, TRA stated its intent to continue using MTRFA’s existing vendor (Ceridian), and asked MTRFA to extend its contract with Ceridian for that purpose, noting that TRA would assume that contractual obligation. Prior to this letter, there were meetings between TRA and MTRFA staff to address the issues raised in the MTRFA Executive Director’s “Critical Time Sensitive Issues for MTRFA Merger with TRA.”

⁴⁷ April 19, 2006 Letter from Mark Kerr, of the State Auditor’s Office, to MTRFA President Downing.

⁴⁸ April 25, 2006 Letter from MTRFA President Downing to State Auditor Anderson.

⁴⁹ The State Auditor’s April 11, 2006 press release, and her April 11, 2006 testimony, advocated passage of Consolidation Legislation that would make MTRFA’s merger with TRA effective in 2006, and would limit MTRFA’s ability to incur additional liabilities prior to the merger. It did not suggest litigation.

May 8, 2006 – Special MTRFA Board Meeting

At a Special Meeting, the MTRFA Board passed a resolution creating the Liquidating Trust. Among other things, the resolution authorized the Executive Director and President to hire an independent accountant or actuary to estimate the amount needed in the Trust, designated the depository for the funds, and appointed a committee, consisting of MTRFA’s President and two of its attorneys, to select the Liquidating Trustee.

The MTRFA Board members and Executive Director also signed letters dated May 8, 2006 requesting indemnification under the Non-Profit Statute [Minn. Stat. § 317A.521] “by MTRFA, (or any trust created by MTRFA to assist in the orderly transfer of assets or liquidation of MTRFA).” The MTRFA Board passed a resolution to hire “Special Legal Counsel” under the Non-Profit Statute [Minn. Stat. § 317A.521, subd. 1(e)] “as quickly as possible” to provide an opinion regarding the eligibility of MTRFA fiduciaries for indemnification under MTRFA’s Articles of Incorporation and Minn. Stat. § 317A.521.⁵⁰

May 10, 2006 – Engagement Letter from Financial Advisors, LLC, to MTRFA

MTRFA received an engagement letter from Financial Advisors, LLC, to calculate the amount that would be placed in the Liquidating Trust.

May 16, 2006 – Memorandum from MTRFA Executive Director to TRA Executive Director

In this memorandum, the MTRFA Executive Director “memorialized” their May 11, 2006 discussions and sought TRA’s assurance that the MTRFA Board would be held harmless if it extended the contract of Ceridian Corporation for the handling of MTRFA annuity payrolls.

May 16, 2006 – MTRFA’s Special Committee Meeting

MTRFA’s Special Committee comprised of MTRFA’s President Downing and MTRFA attorneys Butterbrodt and Lazarus, held a telephone conference and appointed Thomas King as the “Special Legal Counsel of the Minneapolis Teachers’ Retirement Liquidating Trust.”

May 18, 2006 – Letter from TRA Executive Director to MTRFA Executive Director

In this letter, the TRA Executive Director explained TRA’s request for an extension of the Ceridian contract, and agreed to hold the MTRFA Board harmless for extending the contract. TRA’s Executive Director also provided MTRFA’s Executive Director with information she had requested regarding the assignment of MTRFA’s lease.

May 18, 2006 – Liquidating Trust

MTRFA’s President signed the Liquidating Trust Agreement on behalf of MTRFA as “Grantor.”

⁵⁰ MTRFA Board of Trustees Special Meeting minutes – May 8, 2006.

May 18, 2006 – House of Representatives, Committee on Rules and Legislative Administration (Hearing of Consolidation Legislation HF2847/SF1057)

Because the Consolidation Legislation had not met committee deadlines agreed to jointly by the House and Senate, the bill went to this committee. As a procedural matter, the language of the 2006 consolidation proposal was inserted into SF1057, which thereafter became the Consolidation Legislation. The committee heard no testimony, but made two minor amendments to SF1057, as requested by two of the authors, Rep. Dennis Ozment and Rep. Paul Thissen.⁵¹

May 18, 2006 – House of Representatives, Ways and Means Committee (SF1057)

No MTRFA employee or board member testified. Testimony was taken from two individuals in support of an attempted amendment to the bill not directly related to the consolidation of MTRFA and TRA. The amendment failed. Another minor amendment, advanced by Rep. Dennis Ozment, was adopted.⁵²

May 20, 2006 – House and Senate Floors (SF1057)

In the early morning hours, at the close of an all-night session, the House of Representatives passed the 2006 Consolidation Legislation, SF1057. The Senate then re-passed SF1057.

May 22, 2006 – 2006 Consolidation Legislation

The Consolidation Legislation was presented to Governor Tim Pawlenty.

May 22, 2006 – Liquidating Trust

Trustee of the Liquidating Trust, Harry Haynsworth, signed the Liquidating Trust Agreement.

May 24, 2006 – MTRFA Board Meeting

The minutes of the May 24, 2006 regular meeting of the MTRFA Board made **no** reference to the Liquidating Trust or the appointment of Special Legal Counsel King, although other issues regarding SF1057 and MTRFA's consolidation with TRA were discussed. The minutes of the April 19, 2006, regular meeting of the MTRFA Board were approved, but the minutes of the May 8, 2006 Special Meeting (at which the Liquidating Trust was approved) were not mentioned.⁵³

During the meeting, the MTRFA Board approved the proposed 2007 MTRFA budget that showed the July 1, 2006 merger date. According to the meeting minutes, the approved budget would be sent to TRA "for their approval."

⁵¹ Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=21&ls_year=84.

⁵² Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=27&ls_year=84.

⁵³ MTRFA Board of Trustees meeting minutes – May 24, 2006. According to the unofficial minutes of the MTRFA Board's final meeting on June 21, 2006, the May 8, 2006 special meeting minutes were approved at the June 21, 2006 meeting.

May 26, 2006 – 2006 Consolidation Legislation

Governor Pawlenty signed the Consolidation Legislation, which was filed by the Secretary of State as 2006 Laws of Minnesota Chapter 277.

May 26, 2006 – Letter from Financial Advisors, LLC, to MTRFA’s President

Financial Advisors, LLC, estimated that \$1,532,178 was needed in the Liquidating Trust.

May 26, 2006 – Liquidating Trust

MTRFA transferred \$1,532,178 from the special retirement fund to the Liquidating Trust.

May 26, 2006 – MTRFA – CD Request

MTRFA’s Executive Director made the first request of a staff member for a Compact Disk (CD) containing the names and addresses of all members of MTRFA.

May 26, 2006 – Email from TRA to MTRFA’s Executive Director

TRA asked about the \$90,000 in MTRFA’s budget relating to “fiduciary insurance.”

May 27, 2006 – 2006 Consolidation Legislation

Under the Consolidation Legislation, MTRFA would be unable to incur any new or additional contractual liability or obligation without TRA’s approval as of this date.

May 31, 2006 – Email from TRA to MTRFA’s Executive Director

TRA again asked about the \$90,000 in MTRFA’s budget relating to “fiduciary insurance.”

May 31, 2006 – MTRFA Letters to Investment Managers

In a series of letters, MTRFA’s Executive Director informed MTRFA’s investment managers of the Consolidation Legislation. The letters noted that SBI had requested that the portfolio assets be transferred in cash so the cash would be available for transfer by June 19, 2006. The letters also noted that any outstanding investment management fees after June 30, 2006, should be directed to SBI.

June 1, 2006 – Liquidating Trust

TRA and the Office of the State Auditor learned of the existence of the Liquidating Trust when Liquidating Trustee Harry Haynsworth and his attorney, Mr. Thomas Heffelfinger, came to visit each of the offices, and disclosed the existence of the Liquidating Trust.⁵⁴ Both entities called for the prompt elimination of the Trust and the transfer of the assets to TRA as specified in statute.

June 1, 2006 – MTRFA’s Special Legal Counsel

MTRFA’s special legal counsel sent a letter concluding that the MTRFA Trustees and Executive Director were entitled to statutory immunity under the Non-Profit Statute.

⁵⁴ Mr. Heffelfinger and Mr. Haynsworth also visited the Attorney General and Governor’s Offices on the same date.

June 7, 2006 – Special MTRFA Board Meeting

At a Special Meeting, the MTRFA Board approved resolutions to dissolve MTRFA and to approve “the transfer of assets to [SBI] in compliance with 317A.237.” The minutes noted that SBI requested that all assets be liquidated so cash could be transferred to SBI prior to June 30, 2006. According to the minutes, a June 20 asset transfer date had been discussed. The minutes stated that MTRFA’s Executive Director would ask SBI to indemnify MTRFA for actions taken between June 20 and June 30, 2006, and to be responsible for MTRFA’s performance for the month of June 2006 due to the liquidation process.

“In light of the absolute deadline of June 30, 2006,” the MTRFA Board also unanimously allowed the payment of “severance and any other employee obligations and any outstanding bills before the June 30, 2006 dissolution date to ensure payment upon the recommendation of legal counsel.”⁵⁵ The minutes specifically noted contract extensions with MTRFA’s payroll service provider (Ceridian) and TRA’s agreement to include final MTRFA items in a mailing. The minutes made no reference to the Liquidating Trust even though funds had been transferred to the Liquidating Trust for these obligations.

June 13, 2006 – MTRFA (Private Information on CD)

MTRFA’s Executive Director fired the MTRFA employee who had been asked to make a CD containing data on MTRFA members.

June 14, 2006 – MTRFA (Insurance Coverage)

According to the insurance agency, MTRFA’s \$118,996 six-year fiduciary insurance run off tail endorsement was ordered.

June 19, 2006 – Liquidating Trust

MTRFA, the MTRFA Board, MTRFA’s Executive Director, the Liquidating Trust, and the Liquidating Trust’s Trustee sued the Minnesota Attorney General and TRA in Hennepin County District Court, seeking a declaratory judgment that 1) the Liquidating Trust was lawfully established; 2) the Board and Executive Director acted lawfully; and 3) TRA was required to indemnify the Board and Executive Director.

June 20, 2006 – State Auditor Press Release

The State Auditor issued a press release entitled “State Auditor Moves to Secure Records of Minneapolis Teachers Retirement Fund,” and subtitled “*Believes Retirement Fund Created Illegal Trust to Withhold Dollars from Merger with TRA.*”⁵⁶

⁵⁵ MTRFA Board of Trustees Special Meeting minutes – June 7, 2006. Generally, MTRFA’s meeting minutes identified when legal counsel attended the meetings. The June 7, 2006 minutes did not list MTRFA’s legal counsel as attending this meeting.

⁵⁶ The press release is available at the State Auditor’s web site:
http://www.osa.state.mn.us/press/2006/MTRFA/MTRFASecureRec_06_press.pdf.

June 20, 2006 – MTRFA (Checks, CD, Staff)

MTRFA issued a series of checks, including those paying the Executive Director’s final severance package (\$357,385), the severance packages for the other MTRFA employees who would become TRA employees (\$181,009), and fiduciary tail coverage insurance (\$118,996).

MTRFA’s Executive Director asked TRA if she could purchase her laptop computer. Because the computer was capitalized as an MTRFA fixed asset, TRA explained that the laptop computer would become TRA property on June 30, 2006, and that TRA would perform a “disk back-up and review” of the laptop.⁵⁷

The MTRFA employee who had been fired for refusing to create the data CD returned to work, submitting a letter to the Executive Director and the MTRFA Board President as a condition of re-employment. She was asked to revise the letter at the direction of the Executive Director.⁵⁸ At about this time, according to the State Auditor Office’s interviews of former MTRFA staff, the Executive Director called a meeting at which she told staff that anyone failing to follow her directives would be fired, losing not only their severance, but employment with TRA as well.

June 21, 2006 – Liquidating Trust

TRA filed counterclaims and sought a Temporary Restraining Order (TRO), arguing the Liquidating Trust was illegal and all assets held by the Liquidating Trust should be turned over to TRA pursuant to the Consolidation Legislation.⁵⁹

June 21, 2006 – Consolidation

The first transfer of funds from MTRFA to the SBI was made (totaling \$705,821,005).

June 26, 2006 – Liquidating Trust

The Hennepin County District Court denied TRA’s request for a TRO. The litigation remains pending as of the date of this report, before the Honorable Harry Crump.

In a letter to MTRFA’s Executive Director dated June 26, 2006, the Liquidating Trustee stated that he and the Liquidating Trust must be covered by MTRFA’s directors and officers’ liability insurance policy. If such coverage was not possible, the Liquidating Trustee stated that he would purchase “the appropriate liability insurance.”

June 29, 2006 – House of Representatives, State Government Finance Committee (Hearing on Liquidating Trust and status of Consolidation)

The committee held a rare, interim legislative hearing after several committee members learned about the Liquidating Trust. State Auditor Pat Anderson told the committee that the will of the legislature had been circumvented. Auditor Anderson denounced the

⁵⁷ July 3, 2006 letter from TRA Assistant Executive Director Wicklund to former MTRFA Executive Director Kilberg.

⁵⁸ The employee provided the State Auditor’s Office with copies of both letters. They are dated June 16, 2006 and June 19, 2006.

⁵⁹ The State Auditor’s Office was not a party to the lawsuit or counterclaims.

Liquidating Trust and refuted the various public statements advanced by MTRFA's attorneys for its legality and necessity. Representatives of TRA disputed the assertion by MTRFA's lawyers that the Liquidating Trust was necessary because the MTRFA Board and Executive Director were insufficiently indemnified under the Consolidation Legislation.⁶⁰

It seems the main purpose [of the liquidating trust] is indemnification, payment of employee severance and other costs that might be trailing after the June 30 consolidation date. . . .

We [TRA] were very troubled [to learn of the Trust]. We had been operating under the assumption that Chapter 277 did provide for trustee indemnification and did provide for TRA to step into the shoes as the successor in interest to Minneapolis Teachers to pay any trailing financial obligations. We had been operating under that assumption and had heard no major issues raised by Minneapolis Teachers about any concerns in this regard.

Laurie Hacking, Executive Director, TRA

Never in our conversations [with MTRFA] had this [dissatisfaction with the indemnification language] ever been alluded to. I mean we just talked about the language, we went over the language—we've been working on it for the past three years—and you know we're going to change the language on indemnification from 'may' to 'shall' to 'must' and finally they insist on having it 'shall indemnify' and we put it in there and at our last meeting we thought that was the way it was going to be. That was... we believed consistently throughout that that was satisfactory. Never did they bring the issue of [Chapter] 317 coverage; granted they were a nonprofit corporation, but they never insisted upon it. They could have very easily said 'instead of 356A, we want the mandatory coverage in 317A', and in both cases it's a good faith coverage. Not only that but, you get to the Liquidating Trust Agreement, they put in there \$150,000 [sic] for the additional tail [insurance] coverage for the next three years and that was never discussed.

Luther Thompson,
Assistant Executive Director, TRA

Several members of the committee were sharply critical of the actions of the MTRFA Board in creating the Trust and openly questioned its legality:

They [the MTRFA Board] had a fiduciary obligation to manage funds for the sole benefit of the Minneapolis Teachers who participate in the program yet—from what I see from reading through this Trust document—is that they took funds that they were obligated to keep for the

⁶⁰ Hearing room audio available at http://www.house.leg.state.mn.us/audio/archivescomm.asp?comm=22&ls_year=84.

sole benefit of the teachers and appropriated it into a Trust solely for the benefit of themselves. As I look through the Liquidating Trust document, which I've only had time to scan, it appears to me that the Trust is established essentially for the sole purpose of indemnification of the Board of Directors and there is no mention of the teachers being beneficiaries of these Trust funds even though it is their money to begin with.

Rep. Chris DeLaForest

The reason any reasonable person buys insurance is because they feel they have a need for the coverage. So it's obvious to me that the only reason that the trustees of the Minneapolis Teachers Retirement Fund took out a [breach of fiduciary responsibility policy] is because they obviously thought they had breached their fiduciary responsibility.

Rep. Phil Krinkie

No former MTRFA Board members or employees testified at the hearing, although two attorneys representing the MTRFA Board addressed the committee. In addition, Attorney Thomas Heffelfinger, representing the trustee of the Liquidating Trust, stated that TRA and MTRFA were governed by different areas of law. He testified that the Liquidating Trust was necessitated in substantial part by the legislature's decision to compress the consolidation period and dissolve MTRFA on June 30, 2006, instead of in 2007 as originally contemplated. Mr. Heffelfinger argued that "30 days" was too fast to adequately consolidate MTRFA with TRA, and that typically a merger of this type would take "12 to 18 months."

Had the legislature not shortened the period [of consolidation] to 30 days, the need for a liquidating trust would have been minimized if not eliminated entirely.

Thomas Heffelfinger,
Attorney for Harry Haynsworth, Trustee of
the Liquidating Trust

Testifying earlier in the hearing, Laurie Hacking of TRA apprised the committee of the status of the consolidation and the level of cooperation TRA had received from MTRFA:

We are on track to meet the deadline, which is tomorrow. . . .

Minneapolis Teachers was initially reluctant to engage in transition activities until the bill was actually signed by the governor so we've had a very concentrated period of time to get this... get all the administrative aspects in place.

Laurie Hacking, Executive Director, TRA

June 30, 2006 – Consolidation

In keeping with the provisions of the Consolidation Legislation, MTRFA ceased to exist.⁶¹ The Consolidation Legislation required MTRFA to transfer all records and documents relating to MTRFA's funds and benefit plans to TRA's Executive Director on or before June 30, 2006. The Consolidation Legislation also required MTRFA to transfer the entire assets of MTRFA's special retirement fund to TRA by June 30, 2006, to be invested by the State Board of Investment (SBI).⁶² MTRFA's Executive Director provided her laptop computer to TRA, but its hard drive had been removed.

July 1, 2006 – Consolidation

In keeping with the provisions of the Consolidation Legislation, MTRFA employees, excluding the Executive Director, became TRA employees until December 31, 2007.⁶³ MTRFA members were transferred to TRA, and were no longer members of MTRFA.

July 3, 2006 – Letter from TRA to Former MTRFA Executive Director

TRA wrote the former MTRFA Executive Director demanding that she "immediately release and turn over the original, specific hard drive that was taken out of the laptop [she] used while MTRFA Executive Director."⁶⁴

July 5, 2006 – Former MTRFA Executive Director (Hard Drive)

The work order for Rolltex Computers' unsuccessful attempt to recover data from a computer received from MTRFA's former Executive Director stated that it was ordered July 5, 2006.

July 10, 2006 - Consolidation

The former MTRFA Executive Director gave a hard drive to TRA that, according to forensic examination, had been actively wiped to a point where the data was totally unrecoverable.

July 19, 2006 – Letter from TRA to State Auditor

TRA requested that the State Auditor perform a special review of MTRFA.

July 26, 2006 – Letter from MTRFA Attorney

MTRFA Attorney Lazarus turned over to TRA the CD containing members' names and addresses.

August 10, 2006 – Letter from Liquidating Trust Attorney to Trustee of the Liquidating Trust

The Liquidating Trust's attorney, Thomas Heffelfinger, enclosed an invoice for \$78,365 in costs and services incurred in the Liquidating Trust matter during the time period of May 25, 2006 (inception) through the end of July 2006.

⁶¹ 2006 Minn. Laws, ch. 277, art. 3, § 9, subd. 7 (a).

⁶² See 2006 Minn. Laws ch. 277, art. 3, § 9, subds. 4, 5.

⁶³ 2006 Minn. Laws ch. 277, art. 3, § 43.

⁶⁴ July 3, 2006 letter from TRA Assistant Executive Director Wicklund to former MTRFA Executive Director Kilberg.

August 11, 2006 – MTRFA

The law firm of Moss & Barnett provided TRA and the State Auditor’s Office with original detailed MTRFA attorney bills.

August 29, 2006 – Legislative Commission on Pensions and Retirement

During a portion of the hearing devoted to an update on the implementation of 2006 pension legislation, Laurie Hacking of TRA testified that efforts were ongoing to eliminate the Liquidating Trust and to have the Trust assets transferred to TRA in compliance with Chapter 277. Various legislators expressed disdain about the Trust, with Sen. Cal Larson asking “who had approved it” and who knew about it since the membership of the Pension Commission had not been formally apprised of it prior to the final passage of the Consolidation Legislation. Sen. Larry Pogemiller, Chairman of the Pension Commission, stated that he wished the Liquidating Trust would be dissolved.⁶⁵

September 8, 2006 – Letter from Liquidating Trust Attorney to TRA Attorneys (Minnesota Attorney General’s Office)

On behalf of TRA, its attorneys (from the Minnesota Attorney General’s Office) sought reimbursement from the Liquidating Trust of approximately \$1,380,000.⁶⁶ That amount represented obligations that were paid by MTRFA on or before June 30, 2006, and assumed by TRA. More specifically, TRA sought reimbursement for those items that had been used by MTRFA to calculate the funding requirements of the Liquidating Trust, but then were paid by MTRFA prior to June 30, 2006.

In a letter dated September 8, 2006, Attorney Heffelfinger responded:

On behalf of the Liquidating Trustee, we have reviewed TRA’s claims and sections of the Liquidating Trust relevant to payment of claims and have concluded that the Liquidating Trustee lacks the authority to pay claims of TRA at this time. First, and perhaps most importantly, the Liquidating Trustee does not have the power to pay a claim of the TRA prior to the termination of the Trust.⁶⁷

The letter further explained:

[The Liquidating Trust Agreement] states specifically that the Liquidating Trustee has the power “to pay or compromise claims, obligations and liabilities of the Grantor [MTRFA], Initial Beneficiaries [MTRFA’s Board and Executive Director], and Secondary Beneficiaries [creditors] from the Liquidating Trust.” Specifically excluded from that list of claimants is the Tertiary Beneficiary, the TRA.⁶⁸

⁶⁵ Commission meeting audio available at <http://www.commissions.leg.state.mn.us/lcpr/meetinghistory.htm>.

⁶⁶ TRA’s attorneys’ requests were dated July 25, 2006, August 1, 2006, and August 30, 2006.

⁶⁷ September 8, 2006 Letter from Attorney Heffelfinger to Ms. DeMeules and Mr. Murphy (both of the Office of the Attorney General).

⁶⁸ *Id.*

According to Attorney Heffelfinger, TRA's interest in the corpus of the Liquidating Trust is limited to the remainder of the trust upon its termination. The letter points out that "TRA is designated as the 'Tertiary Beneficiary' whose interests in the corpus of the Trust are subservient to those of the Initial Beneficiaries [the MTRFA Board and Executive Director] and Secondary Beneficiaries [creditors]." The letter also reminded TRA that: "Of course, upon a negotiated termination of the Trust, the remainder of the assets in the Trust would be promptly transferred to TRA."

Attorney Heffelfinger's letter concluded with a reminder that the Liquidation Trustee was looking forward to receiving the State's proposed alternative release language.⁶⁹

June 30, 2012 – MTRFA (Insurance)

The six-year fiduciary liability tail coverage purchased by MTRFA ends on June 30, 2012.

⁶⁹ *Id.*

Expenses and Liquidating Trust

Liquidating Trust Funding on May 26, 2006 (Calculations by Financial Advisors, LLC)		Paid by MTRFA 5/26/06 - 6/30/06		Remaining Liquidating Trust Obligations	
Purpose	Amount	Date	Amount	Description	Amount
MTRFA Employees:					
Severance	\$ 166,656.00	6/20/2006	\$ 154,814.00	None - fully paid	\$ -
Vacation Pay-Out	\$ 13,088.00		\$ -	None - TRA assumed obligation	\$ -
Sick Leave Pay-Out	\$ 28,060.00	6/20/2006	\$ 26,195.75	None - fully paid	\$ -
Subtotal:	\$ 207,804.00	Subtotal:	\$ 181,009.75		
Karen Kilberg:					
Compensation	\$ 330,195.00	6/20/2006	\$ 323,519.00	None - fully paid	\$ -
Continuation of Health Insurance	\$ 33,866.00	6/20/2006	\$ 33,866.00	None - fully paid	\$ -
Subtotal:	\$ 364,061.00	Subtotal:	\$ 357,385.00		
Lease Obligation	\$ 141,398.00	6/19/2006	\$ 4,553.62	None - TRA assumed obligation	\$ -
		6/28/2006	\$ 4,553.62		
Fiduciary Liability Insurance	\$ 156,776.00	6/20/2006	\$ 118,996.00	None - fully paid	\$ -
Professional Fees:					
Investment Services	\$ 305,000.00		\$ -	None - TRA assumed obligation	
Legal Fees	\$ 100,000.00				
Butterbrodt		5/26/2006	\$ 12,454.18	Best & Flanagan (Heffelfinger)	
Butterbrodt		6/26/2006	\$ 11,840.88	5/25/06 - 7/31/06	\$ 78,365.91
Butterbrodt		6/30/2006	\$ 2,991.48	August and beyond	unknown
Moss & Barnett		5/26/2006	\$ 25,225.83		
Moss & Barnett		6/19/2006	\$ 9,413.30		
Moss & Barnett		6/23/2006	\$ 20,198.86		
Moss & Barnett		6/27/2006	\$ 27,821.00		
Moss & Barnett		6/30/2006	\$ 12,737.35		
Fredrikson & Byron		6/19/2006	\$ 13,167.50		
Subtotal:		Subtotal:	\$ 135,850.38		
Trustee Fees	\$ 50,000.00		\$ -	Haynsworth - no invoices	unknown
Annuity & Employee Payroll	\$ 19,050.00		\$ 7,897.16	None - TRA assumed obligation	\$ -
Accounting Services	\$ 20,000.00		\$ 10,000.00	None - fully paid, or TRA assumed obligation	\$ -
Doctors' Fees	\$ 7,500.00		\$ 2,052.00	None - TRA assumed obligation	\$ -
Subtotal:	\$ 501,550.00				
Membership Communications	\$ 21,300.00		\$ -	None - TRA assumed obligation	\$ -
Subtotal:	\$ 1,392,889.00				
Add 10% Contingency Reserve	\$ 139,289.00		\$ -		
Total:	\$ 1,532,178.00		\$ 822,297.53		\$ 78,365.91

See footnotes next page

App. 23

Source: The State Auditor's Office created this chart. The Liquidating Trust funding data are from the May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA, and Exhibits; \$1,532,178 was transferred to the Liquidating Trust account at M & I Bank on May 26, 2006, based upon bank documents provided to us by the Liquidating Trust's attorney. The data for the amounts paid by MTRFA are from MTRFA's prepared General Ledger; copies of MTRFA checks; MTRFA prepared Summary of Final Payroll; MTRFA Payroll Register for checks dated 6/20/06; and Exhibits to May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA. The data for the remaining Liquidating Trust obligations are from interviews of TRA staff conducted by the State Auditor's Office, documents received from TRA, and documents received from the Liquidating Trust's attorney.

1 Fee estimate included legal costs related to setting up the Liquidating Trust, winding down the MTRFA not-for-profit entity, and other potential legal issues. Source: Exhibit 10 of May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

2 Fee estimate included accounting services for determining funding requirements for Liquidating Trust and preparation of MTRFA tax returns for FY ending 6/30/06. Source: Exhibit 10 of May 26, 2006 Letter from Financial Advisors, LLC, to Ms. Ann Downing, President MTRFA.

3 75% of amount was paid as salary; 25% of amount was paid to health care savings plans.

4 Amount includes: one year salary of \$147,611, plus \$3,458 (consists of \$5,640 payment to cafeteria plan, plus \$2,000 payment to 457 retirement plan, plus \$685 for "gross-up" on a portion of the cafeteria plan payment minus \$4,867 for a present value adjustment); six month severance of \$73,806; sick leave payout of \$59,080 (75% of sick leave payout); \$19,693 for 25% of sick leave payout paid to a health care savings plan; and vacation payout of \$19,871.

5 Amount for health insurance premiums until Medicare eligible.

6 Payment for June and July 2006 rent.

7 Payment of \$118,996 on June 20, 2006 for six-year fiduciary liability run-off insurance effective June 30, 2006. On April 3, 2006, MTRFA paid \$59,498 for fiduciary liability insurance effective April 6, 2006 through April 6, 2007.

8 According to MTRFA's Cash Disbursement Journal, Financial Advisors, LLC, was paid \$5,000 in a check dated May 25, 2006, and \$5,000 in a check dated June 19, 2006.

9 TRA paid the August rent. TRA gave notice to the landlord to terminate the lease, citing Minn. Stat. § 16B.24, subd. 6. TRA informed us that the Landlord is disputing TRA's attempt to terminate the lease. The dispute between TRA and the Landlord was not resolved as of the date of this report.

**MTRFA Total Administrative Expenses
(Including Expenses Charged to Investing Activity and Real Estate)**

Description	Fiscal Year 2006			Fiscal Year 2005				Fiscal Year 2004			
	Administrative	Investing	Total	Administrative	Investing	Real	Total	Administrative	Investing	Real	Total
	Expenses	Expenses		Expenses	Expenses	Estate		Expenses	Expenses	Estate	
Salaries - Administrative	277,798		277,798	147,546			147,546	137,240			137,240
Salaries - Benefits	294,243		294,243	184,665			184,665	179,506			179,506
Salaries - Securities		287,718	287,718		139,934		139,934		129,925		129,925
Payroll Taxes	34,591	17,426	52,017	23,320	9,805		33,125	22,644	9,294		31,938
Employee Benefits	95,688	48,204	143,892	53,767	22,606		76,373	51,066	20,959		72,025
Postage	27,964		27,964	27,564			27,564	28,630			28,630
Printing	11,742		11,742	8,245			8,245	11,865			11,865
Office Rent	38,219	19,253	57,472	37,000	15,557		52,557	37,712	15,478		53,190
Office Supplies	7,669	3,864	11,533	7,657	3,219		10,876	6,844	2,809		9,653
Telephone and Electricity	4,673	2,354	7,027	4,561	1,918		6,479	7,428	3,049		10,477
Travel	11,864	9,658	21,522	17,026	13,164		30,190	13,257	12,459		25,716
Mileage & Parking	1,372		1,372	1,384			1,384	1,438			1,438
Insurance	92,985	89,247	182,232	33,921	30,522		64,443	30,181	27,289		57,470
Business Expenses	20,327		20,327	9,110	2,247		11,357	15,053	3,647		18,700
Data Processing	93,409		93,409	89,330			89,330	81,515			81,515
Legal Fees	161,987		161,987	11,585		960	12,545	29,576	3,856	2,299	35,731
Actuarial	28,737		28,737	41,738			41,738	51,159			51,159
Audit	23,939	12,060	35,999	13,410	5,638		19,048	12,864	5,280		18,144
Depreciation	5,687	2,865	8,552	9,418	3,960		13,378	12,741	5,229		17,970
Miscellaneous	304	(94,892)	(94,588)	(151)	7,779	148	7,776	171	1,865	25	2,061
Consulting		1,800	1,800		4,200		4,200		4,500		4,500
Total Admin. Expenses	1,233,198	399,557	1,632,755	721,096	260,549	1,108	982,753	730,890	245,639	2,324	978,853

Source: The State Auditor's Office created this chart. The FY2006 data are from MTRFA's prepared General Ledger. The FY2005 and FY2004 data are from the MTRFA's Audited Financial Statements and supporting documentation maintained by the State Auditor's Office. The summaries only include expenses related to administration. We did not include expenses related to benefit payments, money managers, or securities lending.

This page was left blank intentionally.



Teachers Retirement Association

60 Empire Drive • Suite 400 • St Paul MN 55103-4000
651.296.2409 • 800.657.3669 • 651.297.5999 FAX • 800.627.3529 TTY

September 27, 2006

State Auditor Patricia Anderson
Office of the State Auditor
525 Park Street, Suite 500
Saint Paul, MN 55103

Dear Auditor Anderson:

Thank you for the very comprehensive report reviewing the decisions and actions of the Minneapolis Teachers Retirement Fund Association (MTRFA) Board of Trustees and Executive Director preceding MTRFA's final merger with the Minnesota Teachers Retirement Association (TRA). TRA management agrees with the factual content of your report and concurs with the major findings expressed.

Since it first became aware of the existence of the liquidating trust established by MTRFA, the TRA Board of Trustees, as fiduciaries, aggressively sought the transfer to TRA of the \$1.5 million in liquidating trust monies. The merger legislation passed by the Legislature required the transfer of all MTRFA assets without exception. We agree with your conclusions that there is simply no reason for the liquidating trust to continue and to incur additional and unnecessary legal fees.

TRA has been pursuing, through the Minnesota Office of the Attorney General, all available legal means to obtain the liquidating trust monies so that those funds can be transferred to TRA and made available to pay benefits to retired teachers.

Sincerely,

Laurie Fiori Hacking
Executive Director

c: TRA Board of Trustees

This page was left blank intentionally.