

# **The Division of Pensions and Benefits' Oversight of Improper Participation in the Public Employees' Retirement System**

***INVESTIGATIVE REPORT***

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# I. Introduction

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An Office of the State Comptroller (OSC) investigation has found that the Division of Pensions and Benefits (DPB) within the Department of the Treasury has effectively enforced a 2007 law that was enacted to prevent abuses involving professional services providers (PSPs) in the Public Employees' Retirement System (PERS), the State's largest pension system for public employees. DPB achieved significant savings from its investigations, totaling an estimated \$59 million to date. DPB, though, has considerable work remaining to complete its review of PSPs referred by OSC in 2012 who may be improperly enrolled in PERS. DPB is grappling with a PSP case backlog that it is struggling to clear, even nine years later. Given the substantial savings generated by these reviews, this report finds that the State would benefit from DPB being provided with additional resources and from legislation providing DPB with additional powers that would enable it to work more effectively through its backlog.

In 2012, OSC examined whether PSPs retained by municipalities and school districts were enrolled in PERS in violation of *N.J.S.A. 43:15A-7.2* (Section 7.2), which was adopted in 2007 (the "2012 Report").<sup>1</sup> That investigation found that the overwhelming majority of the 58 municipalities and school districts reviewed by OSC had improperly enrolled PSPs in PERS. The 2012 Report identified PSPs, principally lawyers, who were improperly enrolled in PERS and detailed the ways in which municipalities and school districts either failed to analyze how the law applied to PSPs or improperly analyzed the law. OSC referred the names of 202 professionals to DPB for investigation.

OSC also recommended that DPB develop a comprehensive checklist to certify the PERS eligibility of PSPs; that DPB retroactively review PSPs' pension credits; that additional state resources be allocated to address questionable PERS enrollments; and that municipalities and school districts obtain advice regarding PERS eligibility from "DPB or an impartial attorney who does not have a personal interest in the outcome of the opinion."

This report provides OSC's findings regarding DPB's progress in eliminating improperly enrolled PSPs from PERS and recommendations regarding completing a comprehensive review of all improperly enrolled PSPs. In general, OSC finds that:

- DPB now oversees the Pension Fraud and Abuse Unit (PFAU) within the Department of the Treasury to investigate fraud and abuse in the State's pension systems. According to PFAU, these efforts have resulted in an estimated savings to the State of approximately \$59 million. PFAU, however, has a backlog of 241 PSPs to investigate, including investigations into 60 PSPs from the original list referred by OSC in 2012. Further, PFAU has largely not investigated whether PSPs enrolled in PERS through other state and local entities—including authorities, commissions, fire districts, and boards—have been properly enrolled.

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<sup>1</sup> Office of the State Comptroller, *Investigative Report: Improper Participation by Professional Service Providers in the State Pension System* (July 17, 2012), [https://www.nj.gov/comptroller/news/docs/pensions\\_report.pdf](https://www.nj.gov/comptroller/news/docs/pensions_report.pdf).

- PFAU has inadequate statutory authority to compel public employers to comply with requests for information in Section 7.2 investigations. PFAU would likely be more effective and efficient if the Legislature equipped it with the powers to require public employers to cooperate with Section 7.2 investigations.
- PFAU's staff of three Section 7.2 investigators appears to be insufficient. The potential for substantial cost savings through the prevention of fraud and abuse in PERS, both directly in individual matters and as a broader deterrent, may justify adding more staff to PFAU. PFAU staff advised OSC that because of insufficient staff, it has not been able to clear its backlog of cases or proactively evaluate whether many entities that enroll members in PERS are violating Section 7.2. Although the State stands to save considerable money through the resolution of Section 7.2 investigations, PFAU has never conducted a cost-benefit analysis to determine the appropriate number of staff needed to perform its investigations to achieve the greatest anticipated savings to the State.
- Municipalities and school districts appear to be complying with the reforms enacted in 2007 at a much higher rate than they were in 2012. OSC sampled 115 municipal professionals and 21 school district professionals. The sampling found that with the exception of two PSPs who are currently being investigated by PFAU, there were no professionals improperly enrolled in PERS. The reforms initiated by the Legislature through the enactment of Section 7.2 thus appear to be working.

OSC makes two recommendations in this report to ensure ongoing compliance with Section 7.2, and to increase the capacity of DPB to identify and deter violations of New Jersey's pension laws.

## II. Background

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### A. Legislative Reforms to Pension Laws

In 2005, Governor Richard J. Codey issued an executive order establishing the Benefits Review Task Force (the “Task Force”) to conduct a comprehensive review of employee benefits for state and local government workers. The Task Force was charged with:

(1) examin[ing] the current laws, regulations, procedures and agreements governing the provision of employee benefits to State and local government workers, (2) analyz[ing] current and future costs of the benefits, (3) compar[ing] the level of benefits provided to government employees in this State to the benefits provided to other workers, and (4) recommend[ing] changes to the laws, regulations, procedures and agreements designed to control the costs of such benefits to the State’s taxpayers, while ensuring the State’s employees a fair and equitable benefit system.<sup>2</sup>

In its final report issued in December 2005, the Task Force recognized that “since the principal purpose of any public retirement plan is to provide adequate retirement benefits, such coverage should only be extended to ‘true’ public employees.”<sup>3</sup> The Task Force found that:

[T]he rules that allow the politically well-connected to game the system for their own benefit must be changed. The pension system exists to serve public employees who dedicate their careers to government and the eligibility rules must ensure that only they can participate. When non-deserving individuals are allowed to essentially freeload off the system, everyone loses. The bottom line is the system must be returned to those for whom it was designed.<sup>4</sup>

The Task Force recommended two specific changes to pension laws. First, it recommended independent contractors such as PSPs not be eligible for a pension because they “simply do not meet the original purpose of the public retirement plan and should not be eligible to participate in any pension plan.”<sup>5</sup> Second, the Task Force recommended the elimination of “tacking,” a practice used by PSPs retained concurrently by multiple municipalities and school districts to increase their pension payments.

In 2006, a Special Session Joint Legislative Committee on Public Employee Benefits Reform (the “Joint Committee”), utilizing the Task Force report as a starting point, recommended legislative changes to New Jersey’s pension and health benefits systems.<sup>6</sup> Specifically, the Joint Committee recommended:

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<sup>2</sup> See Executive Order No. 39 (Acting Governor Richard Codey, 2005), <https://nj.gov/infobank/circular/eoc39.htm>.

<sup>3</sup> State of New Jersey, Benefits Review Task Force, *The Report of the Benefits Review Task Force to Acting Governor Richard J. Codey*, at 18 (Dec. 1, 2005), [https://www.state.nj.us/benefitsreview/final\\_report.pdf](https://www.state.nj.us/benefitsreview/final_report.pdf).

<sup>4</sup> *Id.* at 4.

<sup>5</sup> *Id.* at 18.

<sup>6</sup> 2006 Special Session Joint Legislative Committee, *Public Employee Benefits Reform Final Report* (Dec. 1, 2006), [https://www.njleg.state.nj.us/propertytaxsession/jcpe\\_final\\_report.pdf](https://www.njleg.state.nj.us/propertytaxsession/jcpe_final_report.pdf).

The enactment of legislation to exclude all professional service contractors from membership in PERS. The legislation should terminate immediately the membership of all existing contractors and prohibit future contractors from enrolling in PERS.<sup>7</sup>

On May 9, 2007, the Legislature enacted Section 7.2 in response to the Joint Committee’s recommendation. That statute mandated PSPs be removed from PERS, stating that “[a] person who performs professional services<sup>8</sup> for a political subdivision of this State or a board of education, or any agency, authority or instrumentality thereof, under a professional services contract . . . on the basis of performance of the contract, shall not be eligible for membership in [PERS].”<sup>9</sup> The statute applied prospectively “following the expiration of an agreement or contract in effect on the effective date” and prohibited PSPs from relying on contract extensions to continue their enrollment in PERS. Section 7.2 also prohibited from enrollment in PERS any person who “meets the definition of independent contractor as set forth in regulation or policy of the federal Internal Revenue Service.”

In December 2007, the Department of Community Affairs, Division of Local Government Services (LGS) sent a notice providing guidance regarding Section 7.2 to municipalities and school districts. DPB also sent those same entities a letter dated May 6, 2008 as a supplement to the notice.

Lawmakers’ focus on reforms to the pension laws continued with additional legislation. In 2010, the Legislature enacted legislation that prohibited certain part-time employees from enrollment in PERS and ended the practice of “tacking.”<sup>10</sup> In 2011, the Legislature enacted legislation that required a government entity’s certifying officer—the employee responsible for submitting information to the pension boards—to undergo training by DPB regarding pension eligibility. That law also required the certifying officer and the officer’s immediate supervisor to certify that each enrollment or transfer of a member into the State-administered retirement systems is in accordance with the law, and subjected them to criminal penalties for false statements knowingly made in connection with a member’s enrollment.<sup>11</sup>

## B. OSC’s 2012 PSP Investigation and Report

In 2012, OSC completed an investigation regarding whether municipalities and school districts in New Jersey were complying with Section 7.2.<sup>12</sup> As part of that investigation, OSC obtained information regarding professionals who were providing services to municipalities and school districts. OSC cross-

<sup>7</sup> *Id.* at 83.

<sup>8</sup> *N.J.S.A.* 43:15A-7.2(b) incorporates the definition of professional services at *N.J.S.A.* 40A:11-2. That statute defines professional services as “services rendered or performed by a person authorized by law to practice a recognized profession, whose practice is regulated by law, and the performance of which services requires knowledge of an advanced type in a field of learning acquired by a prolonged formal course of specialized instruction and study as distinguished from general academic instruction or apprenticeship and training. Professional services may also mean services rendered in the provision or performance of goods or services that are original and creative in character in a recognized field of artistic endeavor.” *N.J.S.A.* 40A:11-2(6). Accordingly, attorneys, physicians, engineers, architects, accountants, auditors, and other individuals providing “professional services” who perform services as a result of a professional services contract with a public employer are ineligible for participation in PERS or the Defined Contribution Retirement Program (DCRP) as a result of those services. See DPB Fact Sheet #84, *Independent Contractors, Professional Services Contracts, and Pension Enrollment* (July 2021), <https://www.nj.gov/treasury/pensions/documents/factsheets/fact84.pdf>.

<sup>9</sup> *N.J.S.A.* 43:15A-7.2(a).

<sup>10</sup> *N.J.S.A.* 43:15A-25.2(a); *N.J.S.A.* 43:15A-7(d)(4).

<sup>11</sup> *N.J.S.A.* 43:3C-15.

<sup>12</sup> 2012 Report.

referenced the names of those professionals with PERS data and developed a list of 332 PERS-enrolled professionals providing such services for 228 different municipalities and school districts. OSC sent a survey to 58 of those municipalities and school districts regarding the PSPs they retained.<sup>13</sup> OSC requested professional services contracts, appointing resolutions, information submitted to PERS regarding the enrollment of the identified PSPs, and all documents evidencing the analysis required by Section 7.2 for enrolling or maintaining the enrollment of the PSP into PERS. OSC also interviewed some of the PSPs who were working as independent contractors in the 58 municipalities.

OSC found that the vast majority of the municipalities and school districts surveyed failed to comply with Section 7.2. OSC identified 202 PSPs enrolled in PERS after 2008 who were either retained through contract or otherwise met the definition of independent contractor under Internal Revenue Service (IRS) guidelines. OSC's investigation also found that a significant number of these PSPs were engaging in "tacking" to increase pension payouts.

The 2012 Report concluded that "the continued PERS enrollment of ineligible professionals, despite the efforts to curb this abuse, has the potential to cost the State millions of dollars in inappropriate future pension benefits."<sup>14</sup> OSC recommended that DPB develop a comprehensive checklist to be used to certify the PERS eligibility of PSPs; that DPB retroactively review PSPs' pension credits; that additional state resources be allocated to address questionable PERS enrollments; and that municipalities and school districts obtain advice regarding PERS eligibility from "DPB or an impartial attorney who does not have a personal interest in the outcome of the opinion." OSC also referred to DPB the names of the 202 potentially ineligible professionals for review and, if appropriate, removal.

## C. The Pension Fraud and Abuse Unit

Following release of the 2012 Report, Governor Chris Christie issued an executive order directing the State Treasurer to establish PFAU, a unit "dedicated to the prevention and investigation of fraud and abuse of the State's pension and benefits systems, including the payment of retirement, disability, and other benefits."<sup>15</sup> The executive order directed PFAU to investigate "public pension claims and payments, including, but not limited to . . . claims of improper participation in the retirement systems."<sup>16</sup> PFAU was directed to "work closely and coordinate with both the Division of Pensions and Benefits within the Department of the Treasury and the Office of the Attorney General" and to "receive referrals from the Office of the State Comptroller on claims of potential fraud and abuse."<sup>17</sup>

PFAU supports DPB by detecting, investigating, and mitigating fraud and abuse of the State's pension systems. The unit is managed by a Head of Investigations who oversees a team of seven investigators. Through most of its existence, PFAU has employed two dedicated Section 7.2 investigators. There are currently four investigators who examine fraudulent accidental disability claims and three investigators who review potential Section 7.2 violations. In addition to their investigative duties, PFAU investigators also monitor and investigate referrals received from a variety of sources and have administrative responsibilities.

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<sup>13</sup> The OSC sampling consisted of 51 municipalities and seven school districts.

<sup>14</sup> 2012 Report, at 9.

<sup>15</sup> Executive Order No. 138 (Governor Chris Christie, 2013), at ¶ 1, <https://nj.gov/infobank/circular/eocc138.pdf>.

<sup>16</sup> *Id.* at ¶ 3.

<sup>17</sup> *Id.* at ¶¶ 4, 5.

Each investigation requires, among other things, the assigned investigator to review documents, conduct witness interviews, obtain any outstanding documents from the municipality or school district, draft decision letters, present findings to the Board, and, if necessary, testify during litigation.

## D. Enrollment and Purchase Bureau

The Enrollment and Purchase Bureau (the “Enrollment Bureau”) is a unit within DPB responsible for, among other things, processing applications for enrollment in, and transfer to, the pension systems. The certifying officer of a government entity submits applications for enrollment in PERS to the Enrollment Bureau through a web-based program known as the Employer Pensions and Benefits Information Connection (EPIC). The Enrollment Bureau requires the certifying officer to approve the application and to indicate whether the applicant was awarded a professional services contract. If the certifying officer answers in the affirmative, EPIC will automatically deny the application. EPIC will also automatically deny an application if the certifying officer indicates that the applicant works less than 32 hour per week for a municipality or school district or less than 35 hours per week for the State.<sup>18</sup> The certifying officer’s supervisor must also approve the enrollment application. A government entity may appeal or resubmit an application that has been rejected by EPIC. The Enrollment Bureau will refer potential Section 7.2 violations to PFAU.

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<sup>18</sup> N.J.S.A. 43:15A-7(d)(4).



# III. Methodology

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OSC initiated this investigation to determine whether municipalities and school districts are complying with Section 7.2. OSC also assessed whether DPB implemented the recommendations from the 2012 Report and investigated whether the 202 PSPs were appropriately enrolled in PERS.

To perform this review, OSC analyzed the pension eligibility of a sample of PSPs currently retained by municipalities and school districts. OSC selected municipal professionals using information contained in the Department of Community Affairs's 2017 Municipal Revitalization Index (MRI), a ranking of New Jersey municipalities based on financial distress. OSC selected professionals from municipalities that were in the most distressed category, least distressed category, and in the middle of the MRI ranking. OSC used the above information, along with other publicly available resources, to establish a representative sample of municipalities.

In total, OSC selected for examination 115 municipal professionals who had been retained by a total of 215 different municipalities. Approximately half of the sampled professionals were retained by more than one municipality. The sample included professionals from every county.

OSC also selected 21 school district professionals using information contained in an online database that classifies New Jersey school districts. Using this data, OSC selected 21 school districts that were spread among the various District Factor Groups developed by the Department of Education (DOE). OSC located the professionals representing these school districts in the Comprehensive Annual Financial Report (CAFR) issued by the DOE.<sup>19</sup> OSC used the above information, along with other publicly available resources, to ensure the sample included a representative mix of school districts. The sampled professionals provided services to school districts located in every county.

OSC conducted multiple interviews with employees of PFAU and the Enrollment Bureau. OSC reviewed governing regulations, statutes and case law, along with memoranda, DPB fact sheets, and various IRS publications. OSC also examined PFAU databases that track the current status of all Section 7.2 investigations, as well as a PFAU database that estimates long-term savings to the State resulting from the removal of improperly enrolled PSPs from PERS.

OSC provided DPB with a discussion draft of this report and asked for comment on the findings and recommendations set forth herein. DPB's response has been considered and, to the extent appropriate, incorporated into this report.

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<sup>19</sup> Department of Education, *Comprehensive Annual Financial Report and Auditor Management Report District Report Search*, <https://www.nj.gov/education/finance/fp/cafr/search/20> (last visited July 28, 2021).

# IV. Investigative Findings

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## A. PFAU's Investigations Have Saved an Estimated \$59 Million, But a Significant Backlog of Cases Remains

In 2012, OSC found that “despite the clear mandate of Section 7.2 and the accompanying guidance provided to [municipalities and school districts], an overwhelming majority of the surveyed [municipalities and school districts] failed to comply with the statutory requirement to remove independent contractors from PERS.”<sup>20</sup> In total, OSC identified 202 professionals enrolled in PERS in 2008 who were retained through “a [professional service contract] or [were] otherwise ‘unlikely,’ as per IRS guidelines, to be properly considered a government employee due to their concurrent private professional practice.”<sup>21</sup> The 202 professionals were providing services to 159 different municipalities and school districts (134 municipalities and 25 school districts).<sup>22</sup>

DPB has made significant progress investigating the 202 referrals and estimates that these efforts saved the State \$59 million. OSC, however, concludes that its 2012 recommendation as to the referrals is still only partially implemented. Specifically, work remains to clear PFAU’s backlog of cases. Although it has been nine years since the referrals were made, 30 percent of OSC’s referrals remain unresolved. PFAU has further identified an additional 488 PSPs who may be improperly enrolled in PERS, of whom 181 remain the subject of open investigations. Its current backlog of cases, accordingly, could represent a large amount of unrealized savings for taxpayers.

### **1. Thirty Percent of OSC’s Referrals from 2012 Remain Unresolved**

In 2012, OSC identified 202 PSPs who appeared to be improperly enrolled in PERS and referred them to DPB for a review of their pension eligibility.<sup>23</sup> OSC has found that since 2012, DPB has resolved 142 of these referrals. Sixty of the 202 PSPs—or 30 percent—are still being investigated.<sup>24</sup> Information obtained by OSC indicated of the 142 completed referrals, DPB (1) removed 47 PSPs from PERS, (2) reduced PERS credits for 61 PSPs, and (3) administratively closed 50 investigations because the subject PSP was properly enrolled in PERS. OSC’s review of PFAU savings data revealed that the resolution of these investigations has resulted in an estimated savings for the State of approximately \$32 million.<sup>25</sup>

In response to OSC’s discussion draft, DPB stated that its ability to resolve the remaining 60 referrals is impacted by a PSP’s retirement status, litigation, how much the relevant government entity cooperates, and whether additional investigative targets are providing services to the entity under review.

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<sup>20</sup> 2012 Report, at 8.

<sup>21</sup> *Id.* at 9.

<sup>22</sup> *Ibid.*

<sup>23</sup> *Id.* at 33.

<sup>24</sup> The status of these 60 remaining referrals ranges from not initiated to near completion.

<sup>25</sup> PFAU’s savings calculation estimate is based on, among other things, the enrollee’s estimated retirement age, estimated final salary for pension calculation purposes, and life expectancy.

## **2. PFAU Identified 488 Additional PSPs Who May Be Improperly Enrolled in PERS, 181 of Whom Are Still the Subject of Open Inquiries**

PFAU reported that since 2012 it has identified an additional 488 PSPs who may be improperly enrolled in PERS.<sup>26</sup> According to PFAU, investigations into these additional PSPs have resulted in the removal of 52 PSPs from PERS for an approximate savings of \$16 million. Eighty PSPs had their PERS credits partially reduced, resulting in an approximate savings of \$11 million.<sup>27</sup> Combined with the \$32 million in estimated savings from the resolution of 142 OSC referrals, PFAU estimates to date that its work has resulted in a total of approximately \$59 million in savings for the State.<sup>28</sup>

PFAU has also confirmed that 181 of these additional 488 PSPs remain the subject of open investigations. According to PFAU, this number may increase as it obtains additional information through its investigative activities.

## **3. PFAU Has Investigated Few Authorities, Commissions, Fire Districts, and Boards**

OSC's 2012 Report focused on PSPs retained by municipalities and school districts. Similarly, since 2012, PFAU's investigations of PSPs who were improperly enrolled in PERS have focused primarily on municipalities and school districts.

With few exceptions, PFAU has not to date investigated whether PSPs enrolled in PERS through other local and state entities, including authorities, commissions, fire districts, and boards, have been properly enrolled. PFAU staff recognize that there is a likelihood that these entities improperly enrolled PSPs in PERS. PFAU officials told OSC that with its current backlog cleared, it would be able to proactively focus its attention on other state and local entities.

Various state laws authorize municipalities and counties to create separate entities that provide public services, such as water or sewer services, housing, parking, and fire protection. Similarly, the Legislature has either created or authorized the creation of various independent entities that provide specific public services either statewide or in specific regions, sometimes through a bi-state compact with an adjoining state. Together, there are hundreds of such entities that are legally distinct from the State, municipalities, and counties.

These entities employ staff and retain PSPs to assist the entities in carrying out their duties. These entities also commonly enroll employees in PERS. Although it is not possible to determine whether these independent entities have improperly enrolled PSPs in PERS in violation of Section 7.2 without an investigation, the experience with municipalities and school districts suggests that there is a risk that some independent entities improperly enrolled PSPs in PERS.

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<sup>26</sup> According to PFAU, this number consists of (1) additional PSPs PFAU uncovered while investigating OSC's referrals, (2) PSPs referred by the Enrollment Bureau, (3) PSPs identified through the DPB fraud hotline and other sources, and (4) referrals made in response to a 2013 DPB letter sent to certifying officers of municipalities and school districts (described further below).

<sup>27</sup> Some of these PSPs may be subject to further reduction of pension credits due to ongoing investigations in other municipalities or school districts where they were employed.

<sup>28</sup> PFAU explained that its decisions from 11 of these investigations are being challenged in the Office of the Administrative Law. PFAU indicated that if its conclusions are affirmed, the State may save an additional \$7.8 million.

DPB, in its response to OSC's discussion draft, identified seven local entities that PFAU has investigated that are not municipalities or school districts. The unit, however, has not pursued such entities as a regular part of its work to ensure compliance with Section 7.2, and many more entities remain to be reviewed. PFAU officials reported that PFAU would be able to focus its attention on other state and local entities after the unit clears its current backlog.

## B. PFAU Needs Additional Powers and Resources to Clear Its Backlog of Cases

The current backlog of PSP cases, the slow pace of their resolution, and PFAU's limited focus on municipalities and school districts suggests that there is a significant amount of unrealized taxpayer savings. OSC's investigation revealed that PFAU's resolution of the outstanding matters may be expedited through the enactment of legislation compelling cooperation with investigations. Similarly, additional staff may accelerate PFAU's completion of outstanding Section 7.2 investigations and allow it to conduct additional proactive PSP investigations beyond its current focus on municipalities and school districts.

### **1. PFAU Should Be Given the Necessary Legal Authority to Compel Municipality and School District Compliance with Requests Made as Part of Ongoing Section 7.2 Investigations**

PFAU advised OSC that it frequently experiences delays because municipalities and school districts either do not respond, or provide incomplete responses, to requests for information. Resistance by municipalities and school districts delays investigations and drains the limited PFAU resources. By way of example, PFAU is investigating a PSP from a municipality in central New Jersey for questionable PERS enrollment. PFAU has had to make six separate requests to the municipality for compliance with requests for information. This particular municipality did not provide the requested information until over three years after the initial request.

There is no express language in PERS's enabling legislation to compel a municipality or school district, post-enrollment, to comply with requests for information.<sup>29</sup> PFAU likewise has not been authorized by law to use the sorts of powers that other investigatory entities possesses.

To allow PFAU to more effectively and efficiently enforce Section 7.2, OSC recommends that the Legislature provide PFAU with powers that enable it to respond when entities fail to cooperate in a timely, candid, and complete manner with requests made during Section 7.2 investigations. Among other things, it would be appropriate for the Legislature to consider requiring state and local entities to fully cooperate with PFAU during Section 7.2 investigations; authorizing PFAU to issue subpoenas for the documentation necessary to complete its investigations; permitting PFAU to refer the chief financial officer or certifying officer of a non-compliant state or local entity to LGS for potential violations of the Local Government Ethics Law<sup>30</sup>; and shifting the burden of proving compliance with Section 7.2 to a PSP or local government once PFAU has established a *prima facie* case of non-compliance. The State receives a financial benefit from the removal of improperly enrolled PSPs in PERS, and it is thus in the State's best interest to provide PFAU with the powers to ensure compliance with Section 7.2.

<sup>29</sup> In an effort to compel compliance from a local government, PFAU has considered suspending a local government's EPIC account until all requested information has been received. This method of obtaining compliance, however, has not been formally implemented by DPB.

<sup>30</sup> N.J.S.A. 40A:9-22.1 *et seq.*

## **2. Additional Staff May Be Necessary to Accelerate the Completion of Outstanding Section 7.2 Investigations and to Ensure Proactive PSP Fraud Prevention**

OSC previously found that non-compliance with Section 7.2 enrollment requirements had the potential to cost the State millions of dollars in future pension benefits to ineligible PSPs.<sup>31</sup> At the time of OSC's 2012 investigation, DPB had only one part-time investigator assigned to the review and investigation of Section 7.2 cases.<sup>32</sup> In its 2012 Report, OSC recommended "[i]n view of the potential to achieve significant long-term savings . . . that consideration be given to allocating additional State resources to address questionable PERS enrollments."<sup>33</sup>

Since that time, PFAU was established for the explicit purpose of preventing fraud and abuse within the pension system, preserving the integrity of the pension system, and protecting taxpayer dollars. According to PFAU, it has removed or reduced the pension credits of over 200 PSPs, and achieved an estimated savings of \$59 million since its establishment. The retroactive removal of current PERS enrollees who were improperly enrolled potentially represents millions of dollars of estimated savings to the State.

PFAU's ability to resolve its outstanding matters in a timely manner, however, appears to be substantially limited by the number of PFAU investigators. Three PFAU investigators are tasked with conducting all Section 7.2 investigations. Each investigation requires the assigned investigator to review documents, conduct witness interviews, obtain any outstanding documents from the municipality or school district, draft decision letters, present findings to the Board, and, if necessary, testify during litigation. Case files reviewed by OSC revealed two investigations that took over three years to complete because, among other things, the investigator was met with opposition by the PSP's attorney, was required to conduct in-depth investigatory work, and had to deal with uncooperative municipalities.<sup>34</sup>

PFAU representatives reported that PFAU made repeated requests for additional investigators from 2013 until 2019. According to the representatives, these requests were denied because of prohibitions on hiring. PFAU advised that it was permitted to hire three additional employees in late 2019, and assigned one of those employees to investigate potential Section 7.2 violations.<sup>35</sup>

Although DPB made repeated requests for additional investigators, it has not conducted a cost-benefit analysis to determine the number of employees needed to achieve the greatest anticipated savings to the State.<sup>36</sup> Nor has DPB conducted an analysis to determine the estimated savings from investigations into entities other than municipalities and school districts. Given the anticipated savings generated by the removal of improperly enrolled PSPs, it is likely that a cost-benefit analysis would have suggested a potential for additional savings through an increase in staff, and could have been relied on by PFAU to

<sup>31</sup> 2012 Report, at 9.

<sup>32</sup> *Id.* at 32.

<sup>33</sup> *Id.* at 34.

<sup>34</sup> PFAU told OSC that investigations were delayed due to the COVID-19 pandemic, including the inability of investigators to conduct on-site interviews and inspections.

<sup>35</sup> This individual did not commence employment until 2021 as a result of the COVID-19 pandemic.

<sup>36</sup> OSC reviewed an "Annual Report" drafted by PFAU and submitted to Treasury. In the Annual Report, PFAU requests additional staff and points to the savings generated in the past. However, it does not set forth the increased anticipated savings from additional staff.

justify its requests.<sup>37</sup>

In its response to OSC's discussion draft, DPB claimed that it would be "difficult, if not impossible" to predict the precise savings from future Sections 7.2 investigations through a cost-benefit analysis and questioned its usefulness as a tool. The fact that a cost-benefit analysis cannot predict the precise savings that may be generated through additional investigations, however, does not negate its usefulness in estimating whether there is a financial benefit to be obtained if the State assumed the cost of additional investigators.

Accordingly, in view of the potential for significant long-term savings to the State, OSC recommends that DPB, with the assistance of Treasury, evaluate whether the allocation of additional resources to PFAU to allow for the hiring of investigators is appropriate. OSC recommends that DPB perform a cost-benefit analysis to determine the number of staff needed to achieve the greatest estimated savings to the State.

## C. Municipalities and School Districts Are Complying With the Reforms Enacted in 2007 at a Much Higher Rate Than They Were in 2012

In order to assess whether municipalities and school districts complied with Section 7.2 and the recommendations contained in the 2012 Report, OSC conducted a random sampling of 115 PSPs retained by municipalities and 21 PSPs retained by school districts to determine if they were improperly enrolled in PERS. The results revealed that the overwhelming majority of the sampled PSPs were not actively enrolled in the PERS system.

With respect to the 115 PSPs retained by municipalities,<sup>38</sup> OSC initially identified nine who were active in PERS and had made contributions in 2020. Additional research, however, revealed that only two of those individuals may be improperly enrolled in PERS and both are currently under investigation by PFAU.<sup>39</sup>

OSC also sampled 21 PSPs employed by 21 school districts. None was enrolled in, or an active member of, PERS.

OSC's review of the current sampling revealed that municipalities and school districts are complying with Section 7.2 to a significantly greater degree than they were in 2012. OSC's 2012 Report and the establishment of PFAU appear to have led municipalities and school districts to improve their compliance with Section 7.2.

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<sup>37</sup> In its response to OSC's discussion draft, DPB advised it is currently in the process of requesting three additional investigator trainees for PFAU.

<sup>38</sup> OSC ensured that its instant sampling of PSPs did not include any of the individuals previously referred by OSC in 2012.

<sup>39</sup> Regarding the other seven individuals initially identified by OSC, OSC found that one individual was previously investigated by PFAU and determined to be eligible under Section 7.2, and that sufficient evidence—such as job title, location of the individual's office, management duties, and the absence of outside employment—existed to conclude that six of the individuals would likely be classified as employees for purposes of PERS eligibility under Section 7.2.

## D. PFAU Conducts Retroactive Reviews of PSP PERS Enrollees for All Section 7.2 Investigations

During the course of the 2012 investigation, OSC learned that municipalities and school districts that removed ineligible PSPs from PERS failed to retroactively remove the PSPs' pension credits earned after the January 1, 2008 effective date of Section 7.2. As a result, ineligible PSPs were able to retain improperly accrued pension credits.<sup>40</sup> OSC recommended that DPB conduct a retroactive review of the ineligible PSPs' earlier pension credits to ensure that all improperly obtained credits have been captured.<sup>41</sup>

During this investigation, OSC found that DPB implemented this recommendation. After the issuance of the 2012 Report, DPB took affirmative steps to ensure PSPs were appropriately removed retroactive to the effective date of the 2007 law. For instance, in 2013, DPB sent a letter advising all certifying officers of municipalities and school districts participating in PERS to review the employment status for *all* staff and retroactively remove any ineligible PSPs. The letter provided instructions for entities to follow if an ineligible PSP is identified. The letter specifically stated that "individuals found to have been improperly enrolled will be canceled by the Division of Pensions and Benefits." Similarly, DPB advised municipalities and school districts to complete a checklist for each individual who provided professional services and was reported as a member of PERS since January 1, 2008, regardless of whether that individual still worked for the entity.

In addition, PFAU officials told OSC that as part of an investigation, it pursues retroactive adjustments for any pension credits improperly awarded. In support of this statement, PFAU provided OSC a copy of the initial request letter it sends to a municipality or school district upon commencement of an investigation. The letter requests employment documents associated with a PSP under review for the period of January 1, 2007 to the present.

OSC reviewed decision letters—known as "Determination Letters"—that PFAU provided enrollees at the conclusion of a Section 7.2 investigation. In a Determination Letter, PFAU notifies the enrollee of its decision as to whether their PERS enrollment is improper. If found to be improper, the Determination Letter also states that the individual's credits for the applicable period will be retroactively removed from PERS. OSC reviewed Determination Letters sent to two separate PSPs that recommended retroactive removal of pension credits from January 1, 2008, and confirmed that the individuals' pension credits received after 2008 were, in fact, retroactively removed from the individuals' PERS accounts.

OSC also examined a 2017 investigative file concerning the enrollment of a PSP practicing in southern New Jersey. After significant investigation by PFAU, the PSP was found to be ineligible for PERS. PFAU issued a Determination Letter retroactively removing the individual's PERS credits from January 1, 2009 until 2017, a period totaling 96 months. PFAU advised OSC that the removal of this individual's pension credits resulted in an estimated savings of over \$1.1 million.

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<sup>40</sup> 2012 Report, at 17.

<sup>41</sup> *Id.* at 33.

## E. DPB/PFAU Developed a Comprehensive Checklist to Assist Municipalities and School Districts in the Certification of PERS Eligibility of PSPs

OSC found in its 2012 Report that a significant number of surveyed municipalities and school districts failed to conduct Section 7.2 analyses and provided improper explanations or justifications in defending the enrollment in PERS of an ineligible PSP. In order to provide municipalities and school districts guidance regarding a Section 7.2 analysis, OSC recommended that DPB develop a comprehensive checklist to certify the PERS eligibility of the PSP. OSC recommended that the checklist expressly incorporate the IRS's presumption that a professional who is in a private practice and offers services to the public is unlikely to be a government employee.<sup>42</sup>

OSC's current review found that DPB implemented this recommendation. In 2013, DPB developed the Employee/Independent Contractor Checklist (the "Checklist") to assist municipalities and school districts in determining the PERS eligibility of an individual based on whether that person should be classified as an employee or an independent contractor. The Checklist was based on IRS guidance and publications governing employment status, and includes 29 questions regarding the individual's employment.<sup>43</sup>

DPB provided the Checklist to the certifying officers of all municipalities and school districts participating in PERS, and instructed them to "complete this checklist for each individual who has provided professional services and was reported as a member of the PERS . . . since January 1, 2008."<sup>44</sup> DPB also enclosed an instruction sheet as to the application of IRS guidelines.<sup>45</sup> The 2013 DPB letter also informed the certifying officers of their statutory obligations under *N.J.S.A. 43:3C-15*.

Presently, the Enrollment Bureau requires a certifying officer of a municipality or school district to complete the Checklist if the Enrollment Bureau suspects the new enrollee is ineligible for PERS enrollment. Likewise, when PFAU initiates an inquiry regarding improper enrollment, the investigator will request a completed checklist from the certifying officer.

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<sup>42</sup> 2012 Report, at 34.

<sup>43</sup> IRS Rev. Rul. 87-41, 1987-1 CB 296 (Rev. Rul. 87-41); see also IRS Publication 963 (Rev. 7/2020), at 29-32, <https://www.irs.gov/pub/irs-pdf/p963.pdf>; IRS Publication 15-A (2021), at 6-7, <https://www.irs.gov/pub/irs-pdf/p15a.pdf>; IRS Publication 1779, at 2, <https://www.irs.gov/pub/irs-pdf/p1779.pdf>.

<sup>44</sup> In 2018, the New Jersey Appellate Division held that although the checklist was a helpful tool in gathering relevant facts necessary to make the employee status determination, it did not encompass all relevant IRS policy and guidelines on the issue. *Petit-Clair v. Board of Trustees*, No. A-2048-16T2, 25 (App. Div. March 1, 2018). Accordingly, the Court held that any determination by the Pension Board as to an individual's employment status must be based on all relevant factors and not just limited to the factors included in the checklist. *Id.* Following the decision in *Petit-Clair*, PFAU revised the Checklist to include additional information to assist municipalities, school districts, and PFAU in determining eligibility pursuant to IRS policy and guidelines. The revised Checklist was provided to the certifying officers of all PERS reporting locations.

<sup>45</sup> See DPB Fact Sheet #84 (July 2021), <https://www.nj.gov/treasury/pensions/documents/factsheets/fact84.pdf>.



## F. PFAU Instructs Municipalities and School Districts to Seek Impartial Advice Concerning the Application of Section 7.2

In the 2012 Report, OSC found that municipalities and school districts in need of legal advice on Section 7.2 requirements were seeking that advice from the individual(s) whose PERS enrollment was being disputed.<sup>46</sup> As an example, during the 2012 investigation, OSC found one municipality had obtained a legal opinion from the municipal attorney, on the attorney's letterhead, advising that the attorney himself could remain in PERS. OSC recommended that municipalities and school districts only seek advice for Section 7.2 enrollment issues from DPB or an impartial attorney who does not have a personal interest in the outcome of the opinion.

For this follow-up review, OSC focused only on actions taken by DPB and PFAU to facilitate municipality and school district compliance with this recommendation. A PFAU representative advised OSC that since the 2012 Report, PFAU has seen very limited instances of a target enrollee providing advice regarding the enrollee's own PERS enrollment or assisting municipalities and school districts in completing the Checklist. When PFAU suspects a target enrollee is assisting a municipality or school district in its response to a request for information, PFAU will conduct a site visit to review the documents and question the entity's certifying officer.

PFAU, for its part, encourages municipalities and school districts to seek legal advice from an independent third party. When PFAU commences an investigation, it sends a letter to the entity advising it to seek advice from an independent third party for assistance addressing a Section 7.2 matter. The same letter also includes language advising the entity that it may also call PFAU with any questions.

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<sup>46</sup> 2012 Report, at 16.

# V. Recommendations

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OSC makes the following recommendations:

1. To effectively and efficiently enforce Section 7.2, the Legislature should provide PFAU with powers that enable it to respond to entities that fail to cooperate in a timely, candid, and complete manner during Section 7.2 investigations; and
2. In view of the potential for significant long-term savings to the State, DPB, with the assistance of Treasury, should perform a cost-benefit analysis and evaluate the appropriateness of allocating greater resources to PFAU to allow for the hiring of additional investigators to perform Section 7.2 investigations.