VESTED RIGHTS: IS THIS THE YEAR THE CALIFORNIA SUPREME COURT REVISITS THE "CALIFORNIA RULE"?

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Moderator: Mary Hao
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AGENDA

- Moderator's Introduction
- Judicial History & Rationale behind the "California Rule"
- Key Cases on Vested Rights
- Issues Before California Supreme Court
- What's Next?

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MODERATOR'S INTRODUCTION

SO CALIFORNIA'S PUBLIC EMPLOYEES THOUGHT 60 YEARS OF ESTABLISHED AND UNCHALLENGED LAW WOULD PROTECT THEIR PENSIONS?

NOT SO FAST . . .

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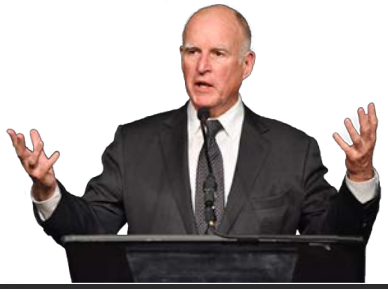
GOVERNOR BROWN

"I have a "hunch" the courts will modify the California Rule, so "when the next recession comes around, the governor will have the option of considering pension cutbacks for the first time in a long time."



SOURCE: SACBEE.COM/ARTICLE194434479, JANUARY 12, 2018

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RETIREMENT CRISIS AND PENSION ENVY?

- 25% of Americans say they will **NEVER** retire.
- 50% of private-sector workers participate in some form of **employer retirement plan**.
- 15% of private-sector workers participate in a **defined benefit pension plan**.

74% of state and local government workers participate in a defined benefit pension plan.

SOURCE: PENSION RIGHTS CENTER, JANUARY 18, 2018, BUREAU OF LABOR STATISTICS DATA)

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PUBLIC PERCEPTION

"Pensions must be based only on actual base salary... not padded with other pay...."

(Little Hoover Commission, Public Pension for Retirement Security, p. 46 (Feb. 2011).)

"Even if the methods employees use [to increase their pensions]... are within the rules of the pension systems, they seem illegitimate because of the appearance that the pension system is being 'manipulated'...."

(Beerman, The Public Pension Crisis (2013) 70 Wash. & Lee L. Rev. 3, 13.)

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JUDICIAL HISTORY & RATIONALE BEHIND THE "CALIFORNIA RULE"

AGENDA

- Theory of Vested Pension Rights
- Limits Of Vested Rights Doctrine
- Issues Raised By Recent Case Law

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THEORY OF PENSIONS AS VESTED RIGHTS

KERN V. CITY OF LONG BEACH (1947)

THE FACTS:

- The City of Long Beach offered pension benefit to city employees after **20 years of service**.
- The pension was equal to **50% of annual salaries**.
- 32 days before Kern completed 20 years of service, the City amended its charter to **eliminate pensions for all persons who were not yet eligible to retire**.

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KERN V. CITY OF LONG BEACH (1947)

HOLDING:

The Supreme Court said that Kern acquired a vested right to a pension which the city could not eliminate without impairing a contractual obligation.

- Pensions are compensation for services performed and part of the employment contract.
- Pensions induce individuals to become and remain public employees.
- Public employees earn pension rights as soon as they perform substantial service for the public employer.

Kern acknowledged that "pension systems must be kept flexible to permit adjustments."

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KERN V. CITY OF LONG BEACH (1947)

Although the court did not need to consider the permissible scope of changes to pension rights, the court said:

> "[A]n employee may acquire a vested contractual right to a pension but that … right is not rigidly fixed by the specific terms of the legislation in effect during any particular period in which [he or she] serves… **The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension**."

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ALLEN V. CITY OF LONG BEACH (1955) ("Allen I")

THE FACTS:

- The city did not offer pension benefits to police and fire employees hired between 1945 and 1950.
- The city then contracted with the state to make employees hired after 1945 part of state pension system.

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ALLEN V. CITY OF LONG BEACH (1955) ("Allen I")

In 1951, the city amended its charter to alter the pension rights of police and fire employees hired prior to 1945 to "**somewhat equalize**" the compensation paid to the pre-1945 and post-1945 employees.

PRE-1945 PLAN

Increased with the compensation paid to active employees and only required active employees to contribute 2% of salary

POST-1945 PLAN

Fixed as a percentage of the employee's highest salary and required a 10% employee contribution.

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ALLEN V. CITY OF LONG BEACH (1955) ("Allen I")

ANALYSIS:

The *Allen I* court acknowledged that vested contractual pension rights **may be modified** prior to retirement, but "**[s]uch modifications must be reasonable** and it is for the courts to determine upon the facts of each case what constitutes a permissible change."

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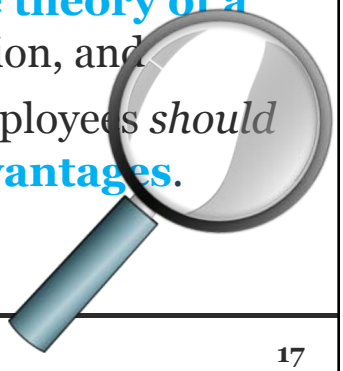
ALLEN V. CITY OF LONG BEACH (1955) ("Allen I")

Allen I announced: What is called "The California Rule"

To be sustained as **reasonable**, modifications to vested pension rights:

- must bear some **material relation to the theory of a pension system** and its successful operation, and
- changes which result in disadvantage to employees *should* be accompanied by **comparable new advantages**.



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ALLEN V. CITY OF LONG BEACH (1955) ("Allen I")

- The *Allen I* court concluded the changes to pre-1945 pension rights were **not reasonable** because they were all detrimental and there was no corresponding increase in benefits.
- The *Allen I* court also stated that the change bore no relation to the functioning and integrity of the pension systems established for the employees.
- Notably, there was no indication that the city would have any difficulty meeting its pension obligations to the pre-1945 employees under the prior system.

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ABBOTT V. CITY OF LOS ANGELES (1958)

THE FACTS:

- The city sought to change from a fluctuating pension benefit to a fixed pension benefit.

The *Abbott* court found the change unreasonable and underscored: "**it is the advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured.**"

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ABBOTT V. CITY OF LOS ANGELES (1958)

The *Abbott* court rejected as "speculation" the assertion that rising costs might otherwise cause the pension system to cease to exist.

"Rising costs alone will not excuse the city from meeting its contractual obligations, the consideration for which has already been received by [the city]."

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BETTS V. BOARD OF ADMINISTRATION (1978)

When positive changes are made to the pension system at any time during employment, such changes become part of the employee's vested pension rights.

"An employee's contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee's subsequent tenure."

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ALLEN V. BOARD OF ADMINISTRATION (1983)("Allen II")

- Constitutional revisions in 1966 turned state legislators from part-time employees making $6,000 per year to full-time public servants making $16,000 per year.
- State legislators who retired prior to 1967 were entitled to pension benefits based on the salaries of active legislators. The 1966 revisions eliminated that provision. But a new COLA formula was implemented in the meantime that substantially increased pension benefits without the need for salary increases.

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ALLEN V. BOARD OF ADMINISTRATION (1983) ("Allen II")

- The *Allen II* court applied a federal contracts clause analysis and focused on the employee's reasonable expectations during employment to define the scope of the contract giving rise to vested pension rights.
- Ruled against legislators who sought COLA increases after they left service.

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ALLEN V. BOARD OF ADMINISTRATION (1983)("Allen II")

Before undertaking its analysis, the Allen II court stated:

"With respect to active employees, we have held that any modification of vested pension rights must be reasonable... and when resulting in disadvantages to employees *must* be accompanied by comparable new advantages."

This is the only time the Supreme Court has replaced the word "should" with "must" when describing the California Rule.

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LEGISLATURE V. EU (1991)

- Statewide proposition: no participant in Legislators' Retirement Plan should accrue any further benefit or any further service towards vesting.
- Supreme Court: Legislators had "**right to earn future pension benefits through continued service, on terms substantially equivalent to those**" existing at the time they began working, or added at any point during their service.

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LIMITS ON THE "CALIFORNIA RULE"

MILLER V. STATE OF CALIFORNIA (1977)

THE FACTS:

- Legislature reduced the mandatory retirement age from 70 years to 67 years.
- At the same time as it reduced the mandatory retirement age, the Legislature increased, for all ages of retirement, the benefit factor used to determine benefits of all members.
  - Nevertheless, the difference between prior maximum benefit at age 70 and current benefit at age 67 was a decrease from $2,365/month to $1,863/month.

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MILLER V. STATE OF CALIFORNIA (1977)

HOLDING:

The Legislature retained the authority to change the statutory provisions relating to duration of permitted employment.

ANALYSIS:

"It is well settled in California that public employment is not held by contract but by statute and . . . no employee has a vested contractual right to continue in employment beyond the time or contrary to the terms and conditions fixed by law."

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MILLER V. STATE OF CALIFORNIA (1977)

- "In view of these long and well settled principles, we conclude that the power of the Legislature to reduce the tenure of plaintiff's civil service position and thereby to shorten his state service, by changing the mandatory retirement age was not and could not be limited by any contractual obligation."
- However, the Court also notes that **pension laws do "establish contractual rights."**

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MILLER V. STATE OF CALIFORNIA (1977)

- Court notes that the scope of permissible modifications of vested pension rights was established in *Allen v. City of Long Beach* and *Abbott v. City of Los Angeles*.
- Here, however, there was "no vested right to remain in public employment beyond the age of retirement established by the Legislature."

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MILLER V. STATE OF CALIFORNIA (1977)

TAKE AWAYS:

- *Miller v. State* does **not** extend extra protection given to pension rights under California law to employment rights.
- No reasonableness or comparable advantage analysis required where no underlying vested right impaired.

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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

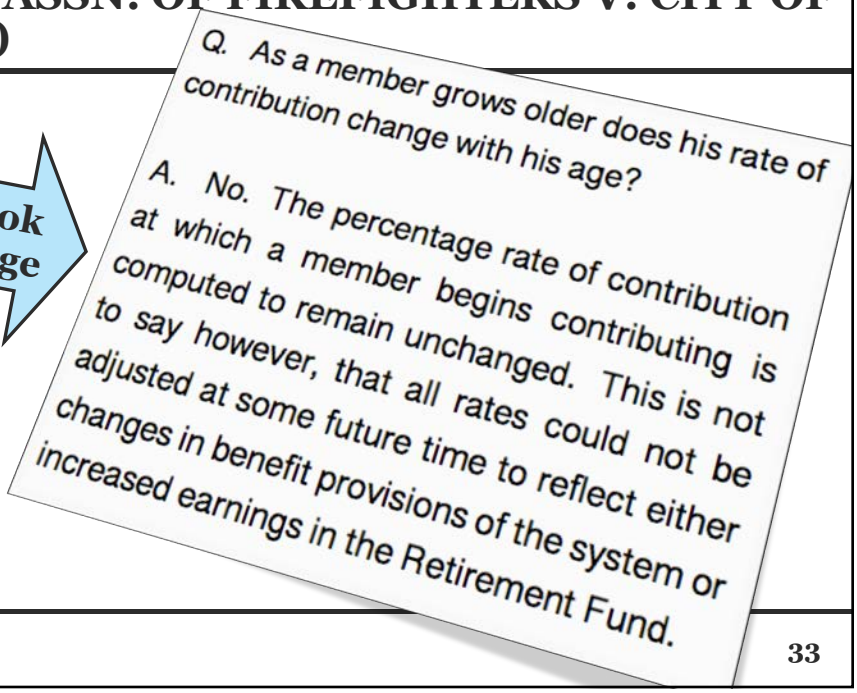
THE FACTS:

- Member contributions were established based on age at entry into the retirement system, and were actuarially determined thereafter.

32

INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

Retirement handbook included this language



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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

Issues identified by Court for decision:

- "(1) whether defendants are authorized by the City's actuarially based retirement system to increase the employees' contributions to the system **without** providing commensurate added benefits to those employees and, if so,
- (2) whether in this instance defendants nonetheless should be **estopped** from effecting such increase because of certain representations contained in retirement handbooks distributed to those employees at the time of employment."

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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

HOLDINGS:

- Retirement system was authorized, upon actuary's recommendation, to add an inflation factor to determination of employee contribution rates without providing commensurate added benefits to those employees, and
- The handbook did not misrepresent the retirement plan to members because it simply noted that member contributions would not change "with his age," it does not tell the member that such rate will never change for any other reason.

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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

Court discusses *Kern, Allen I, Abbott* and *Betts*, then notes:

> "What distinguishes each of these cases from the one before us is the nature of the contractual rights which became vested in plaintiff's members upon their acceptance of employment. In the cases relied upon by plaintiff, employees' vested contractual rights were modified by amendment of the **controlling provisions of the retirement system** in question to reduce (or abolish) the net benefit available to the employees."

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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

"In the present case, no modification was made in the retirement system; instead, the revision in the factor representing future compensation of employees and the resulting revision in the rate of contribution were made pursuant to the charter and ordinances which delineate City's retirement system and prescribe the employees' vested rights."

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INTERNATIONAL ASSN. OF FIREFIGHTERS V. CITY OF SAN DIEGO (1983)

"Change in contribution is implicit in the operation of City's system and is expressly authorized by that system and no vested right is impaired by effecting such change."

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REAOC V. COUNTY OF ORANGE

Question posed to the California Supreme Court by the United States Court of Appeals for the Ninth Circuit:

> **"Whether, as a matter of California law, a California county and its employees can form an implied contract that confers vested rights to health benefits on retired county employees."**

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REAOC V. COUNTY OF ORANGE

- Supreme Court's analysis includes a discussion of a number of lower court of appeal decisions on vested pension rights. As to one of them (*California League v. Palos Verdes Library*), the Court notes:

> "Although we agree with the criticism by some state and federal courts that the *California League* analysis was deficient in **failing to focus explicitly on the 'legislative body's intent to create vested rights**,' or the plaintiff's 'heavy burden' to demonstrate that intent, none of this criticism purports to quarrel with the underlying theory in *California League* that public employee benefits, in appropriate circumstances, could become **vested by implication** [citations omitted]."

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REAOC V. COUNTY OF ORANGE – BUT

- The "legislative intent to create private rights of a contractual nature against the governmental body must be '**clearly and unequivocally expressed**.'"
- "Thus, it is presumed that a statutory scheme is not intended to create private contractual or vested rights and a person who asserts the creation of a contract with the state has the burden of overcoming that presumption."

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KEY CASES PENDING BEFORE CALIFORNIA SUPREME COURT

KEY PENDING CASES

1. ***Marin Assn. of Public Employees v. Marin County Employees Retirement Sys.* (2016) 2 Cal. App. 5th 674 (Supreme Court Case No. S237460)**: largely dispensed with the "comparable new advantage" requirement and takes an expansive view on what constitutes "reasonable changes" to vested pension benefits.

2. ***Cal. Fire Local 2881 v. CalPERS* (2016) 7 Cal. App. 5th 11 (Supreme Court Case No. S239958)**: applied REAOC standard to find no vested right to "airtime"; adopted reasoning in *Marin* and held that pension benefits may be modified prospectively, before retirement, so long as reasonable or substantial pension remains.

3. ***Alameda Deputy Sheriffs' Assn., et al. v. Alameda County Employees' Retirement Assn, et al.* (2018) 19 Cal.App.5th 61 (Supreme Court Case No. S239958)**: agreed with *Marin* on no need for "comparable new advantage," but departed from *Marin* in appearing to require an onerous financial burden to justify any modification.

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MARIN - BACKGROUND INFO

- AB 340/197 amended Gov. Code § 31461, which defines "compensation earnable" under CERL.
- MCERA excludes from "**compensation earnable**":
  - ☒ standby pay, administrative response pay, call-back pay.
  - ☒ cash payments in lieu of health insurance and due to changes in IRC 125 plan.
- Applies to payments and final average salary periods occurring after January 1, 2013.

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MARIN - PETITIONERS' ALLEGATIONS

Violation of Contract Clause:

- Vested right to inclusion of payments in pension calculation.
- Exclusion of pay items will reduce pension benefits.
- No comparable advantage provided.

No determination that payments in lieu of health insurance or for changes to IRC 125 plan were made to enhance retirement benefits.

45

MARIN - ARGUMENTS BY MCERA
NO VIOLATION OF VESTED RIGHT

- PEPRA did not change the law but only clarified that "compensation earnable" – a general definition – did not include this pay.
- PEPRA retained the existing general definition of "compensation earnable" in Gov. Code 31461(a).
- Added a new section (b) that addressed abuses that had arisen – "**spiking**."

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MARIN COURT:

"[W]hile a public employee does have a 'vested right' to a pension, that right is only to a 'reasonable' pension—not an immutable entitlement to the most optimal formula of calculating the pension. **And the Legislature may, prior to the employee's retirement, alter the formula, thereby reducing the anticipated pension. So long as the Legislature's modifications do not deprive the employee of a 'reasonable' pension, there is no constitutional violation**." (2 Cal.App.5th at p. 680.)

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MARIN COURT:

- California Supreme Court did not intend "must" to have a literal meaning, citing *Allen v. City of Long Beach* (1955) 45 Cal.2d 128, 131; *Abbott v. City of Los Angeles* (1958) 50 Cal.2d 438, 449; and other cases that say disadvantages "should" be accompanied by comparable new advantages. (2 Cal.App.5th at p. 698.)
- "Should" is the preferred formulation. "And 'should' does not convey imperative obligation, no more compulsion than 'ought.' [citations] In plain effect, 'should' is 'a recommendation, not . . . a mandate.'" (2 Cal.App.5th at p. 699.)

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MARIN CASE STATUS

- Grant and Hold by California Supreme Court

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THERE "MUST" [OR "SHOULD"?] BE A COMPARABLE NEW ADVANTAGE FOR EVERY DISADVANTAGE

- Was the *Marin* Court correct that the Cal. Supreme Court intended only "should"?
- Was the *Marin* Court correct that only a "substantial and [or?] reasonable" pension need remain?
- Where is that line? Any deference due legislature?
- If a comparable new advantage "must" be provided, does that effectively negate the Supreme Court's original statement that "employee does not have the right to any fixed or definite benefits" – thus prohibiting any meaningful modification?

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DOES THE THEORY COVER ONLY WORK ALREADY PERFORMED OR ALSO APPLY TO FUTURE WORK?

- Right to compensation – only for work already performed.
- Different rule for pensions? Legislature v. Eu: "right to earn future pension benefits through continued service" on same terms as when began working
- *Marin* Court: "Earned in this context obviously means in exchange for services already performed."
- Protection for future accruals "would be a significant, unprecedented change that goes beyond any known theory of deferred compensation." (Monahan, Statutes as Contracts?)

CAL FIRE LOCAL 2881 V. CALPERS (2016)
7 CAL.APP.5TH 115

- PEPRA elimination of "airtime" (purchase of up to five years service credit). (Gov. Code §§ 20909, 7522.46.)
- Plaintiffs: violation of vested pension right.
- Court finds that presumption is against statutory creation of vested rights, citing *Retired Employees Assn. of Orange County, Inc. v. County of Orange* (2011) 52 Cal.4th 1171, 1186, 1189. (7 Cal.App.5th at p. 126.)

CAL FIRE COURT:

- No failure to provide a comparable advantage. (7 Cal.App.5th at p. 130.) Court agrees with *Marin* that "should" is only a recommendation. (7 Cal.App.5th at pp. 130-131.)
- No showing that plaintiffs lost right to a "reasonable" pension, again citing *Marin*. (7 Cal.App.5th at p. 132.)

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SUPREME COURT GRANTS REVIEW

- Review granted April 12, 2017
- *CAL FIRE* will be the **first** case heard by Supreme Court—not being held for *Marin* or *Alameda* cases.
- Fully briefed and waiting for oral argument to be scheduled.

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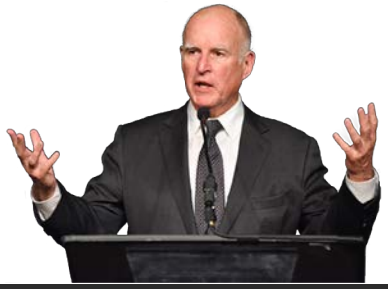
GOVERNOR BROWN WEIGHS IN

- In California Supreme Court, the Governor files the brief on behalf of the State.
- The Governor's brief argues there was no vested right to airtime, AND
- That employees are entitled to a reasonable and substantial pension – no requirement for a comparable advantage for every disadvantage.



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ISSUE RAISED IN PENDING CASES
STANDARD OF PROOF

- *REAOC*: The "legislative intent to create private rights of a contractual nature against the governmental body must be 'clearly and unequivocally expressed.'" (52 Cal. 4th 11171, 1186-1187.)
- Called **"unmistakability" doctrine**.

UNMISTAKABILITY – HOW DOES IT APPLY TO PENSION STATUTES?

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HOW TO APPLY THE STANDARD FROM THE SUPREME COURT'S REAOC OPINION:

- The legislative intent to create private rights of a contractual nature against the government body must be 'clearly and unequivocally expressed.'" (52 Cal. 4th 1171, 1186-1187.)
- REAOC Court applied standard to "implied contracts" for retiree health benefits.
- How does it apply to pension statutes?
- Comes from federal constitutional law; how applied in other states.

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ISSUE RAISED IN PENDING CASES
PROSPECTIVE CHANGES

- The decisions in both *Marin* and *Cal Fire* rested, in part, on the **prospective nature of the changes** at issue in those cases.
  - "Earned in this context obviously means in exchange for services already performed." (2 Cal.App.5ht at at 694 [quoting *White v. Davis* (2003) 30 Cal.4th 528, 566].)
- Other jurisdictions: E.g., *Scott v. Williams* (Fla. 2013) 107 So.3d 379, 388-389 [approving prospective amendment "so long as any benefits tied to service performed prior to the amendment date are not lost or impaired"].)

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ALAMEDA/CONTRA COSTA/MERCED CASES
19 CAL.APP.5TH 61

- Cases involve AB 197 – additional sections to those considered in *Marin*.
- State: CERL always prevented inclusion of certain final comp period "cashouts," "terminal" pay, "on-call" pay; legislature entitled to "clarify" that spiking prohibited.
- Plaintiffs – Disagree, and employees were entitled to rely on retirement board policies that permitted inclusion.

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ALAMEDA COURT:

- "Compensation earnable" always included the inclusion of vacation or other leave "cashed out" in the final compensation period. PEPRA made no change.
- "Terminal pay" not pensionable but retirement systems equitably estopped based on settlement agreements.
- "On call Pay" was pensionable, but PEPRA changed the rule.
- Rule against "pension enhancements" is also new.

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ALAMEDA COURT:

"Much of *Marin's* vested rights analysis-including its rejection of the absolute need for comparable new advantages when pension rights are eliminated or reduced is not controversial, and we do not disagree with it. **However, we must respectfully part ways with our colleagues…when it comes to their application of the law to this specific dispute**."

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ALAMEDA COURT:

"[W]hen no comparative new advantages are given, the **corresponding burden to justify any changes with respect to legacy members will be substantive**."

"[T]otal pension system collapse may be a sufficiently weighty concern to meet this standard…."

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ARGUMENTS BEFORE THE SUPREME COURT

- Plaintiffs: Uphold Court of Appeal, except not on issue of comparable new advantage.
- State: no violation of vested rights because PEPRA rules on final comp clarified existing law and did not create new law.
- State: "equitable estoppel" cannot apply because the retirement board had no authority to grant a benefit.
- State: If Court reaches modification issue, no comparable new advantage is required, minimal modifications do not implicate vested rights, no economic emergency required.

ISSUE RAISED IN PENDING CASES
COMPARABLE NEW ADVANTAGE

Marin, *Cal Fire* and *Alameda*: Courts concluded that California Supreme Court precedent does not require a comparable new advantage for every disadvantage.

- "Should" not "must" remains the Court's preferred expression. And "should" does not convey imperative obligation, no more compulsion than "ought." (*Marin* at 699.)
- Legislature may make "reasonable" modifications; employee entitled only to a "substantial or reasonable" pension. (*Marin* at 702.)

ISSUE RAISED IN PENDING CASES
JUSTIFICATION FOR MODIFICATION

Alameda Court departed from *Marin* Court on standard for assessing change:

- "If the justification for the change is the financial stability of the specific CERL system. . . [would the system] have difficulty meeting its pension obligations."

"MINIMAL" MODIFICATION – HOW DOES IT CUT, FOR OR AGAINST?

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MUST "BEAR A MATERIAL RELATION TO THE THEORY & SUCCESSFUL OPERATION OF A PENSION SYSTEM"

- Is anti-"pension-spiking" in a defined benefit plan a sufficient rationale?
- Modification permitted prior to retirement "for the purpose of keeping a pension system flexible and permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system." (Betts, 21 Cal. 3d at p. 863.)
- Modification permitted to "restrict a party to the gains 'reasonably to be expected from the contract.'" (Allen II, 43 Cal. 3d at p. 120.)
- No immunity in event of "unforeseen advantages or burdens." (Ibid.)

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MUST THERE BE AN ECONOMIC JUSTIFICATION FOR CHANGE AND WHAT IS THE STANDARD?

- "Rising costs alone will not excuse the city from meeting its contractual obligations, the consideration for which has already been received by the city." (Abbott v. City of Los Angeles, 1958)
- *Alameda* Court: "total pension system collapse may be a sufficiently weighty concern."
- What happens if member agencies do not pay their employer contributions?
- Is bankruptcy the only solution?

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WHAT'S NEXT?