VESTED RIGHTS TO PENSIONS – HAS ANYTHING CHANGED

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THE LAW OF VESTING

- Vesting has two meanings
  - Employees/retirees obtain an entitlement to a benefit, typically after a period of years
  - Employees/retirees obtain a lifetime entitlement to a benefit under what has come to be called the "California Rule"
  - Here, we are talking about the latter form of vesting

THE CALIFORNIA RULE

- Pension benefits become vested when an employee begins service for an employer (*Kern* – 1947)
- When positive changes are made to a pension system during employment, such changes become vested as well (*Betts* -- 1978)
- Once vested, pension benefits can be changed, however, changes must
  - Be reasonable (*Allen I* – 1955)
  - Relate to the functioning and integrity of the pension system (Id.)
  - Should or must be accompanied by comparable new advantages (*Allen II* – 1983)
- Employees have the right to earn future benefits through continued service, on terms substantially equivalent to those existing when work commenced (*Eu* – 1991)

THE LIMITS ON THE CALIFORNIA RULE (PRE- CAL FIRE)

- Early case law addressing vested rights issues have emphasized:
  - Employees do not have a right to a particular pension, but only a substantial and reasonable pension (*Kern* – 1947)
  - Pensions must remain flexible to permit adjustments in accord with changing conditions (*Betts* – 1978)
  - "Constitutional decisions have never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change." (*Allen II* – 1983)
- Most vested rights are attained by statute – however, statutes are not primarily contractual in nature, and are generally subject to change

THE LIMITS ON THE CALIFORNIA RULE (*REAOC*)

- Vesting can occur by implication, but the presumption is that a statutory scheme was not intended to create vested rights, and the burden is on plaintiff to prove otherwise (*REAOC*)
- The intent to create a vested right must come from the Legislature, and must be "clearly and unequivocally expressed" (*REAOC*)

VESTING OF MEDICAL BENEFITS VS. PENSION

- Although many kinds of benefits have been asserted to be vested, the primary debate has revolved around pension and retirees health benefits
- Although the courts have not expressly distinguished the analysis applicable to each, as a practical matter, they have treated them somewhat differently
- Retiree health benefits have generally been treated as “vested” only when there is strong evidence from the legislative record that the benefit was intended to last for the life of the employee/retiree

RETIREE MEDICAL BENEFITS

- The leading case on retiree health benefits, RETIRED EMPLOYEES ASSOCIATION OF ORANGE COUNTY, INC., Plaintiff-Appellant, v. COUNTY OF ORANGE, Defendant-Appellee. No. 09-56026 (*REAOC*), decided by the California Supreme Court in 2011, requires a plaintiff to overcome a strong presumption that legislatively enacted benefits are subject to change – i.e. a presumption against vesting
- Because *REAOC* requires a case by case determination of legislative intent, retiree health vesting cases have continued to be brought and occasionally make it to trial
- However, we are not aware of any case in which a plaintiff has prevailed on a retiree health vesting claim since *REAOC*

THE POST *REAOC* WORLD

- After the decision in *REAOC*, the question of everyone's mind was whether a similar analysis would apply to pensions, despite a number of cases dating from 1947 to the present that suggest pension benefits are automatically vested upon the commencement of employment
- The focus in particular, in the area of vested *pension* benefits, is prospective service – i.e. can the benefits of existing employees who have yet to retire be changed for service not yet rendered
- For the most part, pension benefits of retirees are assumed to be vested

POST *REAOC* WORLD

- This is different from the cases discussing retiree health benefits, which often affect both the future rights of current employees, and the rights of those who have already retired
- Although at least one California Supreme Court case has concluded that future pension benefits of current employees cannot be changed (*Legislature v. Eu*), that case is not very well reasoned, and the analysis was essentially an afterthought

PROSPECTIVE BENEFITS MATTER – A LOT

- The importance of the prospective benefit issue cannot be overstated. Liability for current employees generally is 40% or more of the total CalPERS liability for most jurisdictions (typically higher for safety).
- Importantly, many believe we are close to the top of the market, so there is a significant risk that, if a recession occurs, the funded ratio will drop as did in 2009. The only "lever" that could reasonably be expected to reduce pension liability is changes to prospective benefits.
- However, even if the law were settled, changes to CalPERS or the '37 Act would require legislative approval.

RATES ARE UP; EXPECTED RETURNS ARE DOWN

- CalPERS rates are likely to increase by nearly 50% over present levels due to the phasing in of lower assumed return rates, shorter amortization periods, elimination of some smoothing mechanisms, lower mortality, de-risking the investment pool, among other things. Although CalPERS is in the process of lowering its predicted return rate to 7%, CalPERS itself is actually predicting an average 6% return over the next decade. Hence, the numbers are likely to get worse.

PEPRA

- In light of all of this bad news, Governor Brown pushed through PEPRA in 2012. PEPRA created lower cost tiers for "new" employees," and eliminated many abuses such as the inclusion of uniform pay and various forms of spiking such as inclusion in "final compensation" of terminal pay and certain premiums. PEPRA also capped total pensionable compensation for new employees and required new employees to pay 50% of the normal cost of their pensions.

PEPRA

- PEPRA did little to lower the cost of existing employees. But, it did do a few things:
  - It eliminated certain abuses such as "air time"
  - It eliminated the inclusion of terminal pay, payments for unused sick and vacation ('37 Act only)
  - It allowed employers to impose up to a 12% employee contribution for safety employees and 8% for miscellaneous employees

CHALLENGES TO PEPRA REFORMS

- The relatively few provisions of PEPRA affecting existing employees have been challenged judicially
- A number of Courts of Appeal used these challenges to take on various aspects of the "California rule," particularly the issue of whether changes to vested benefits must be accompanied by the granting of equivalent benefits.
- The California Supreme Court granted a hearing in all these cases, but designated two cases, *Cal Fire Local 2881 v. California Public Employees' Retirement System* (***Cal Fire***) and *Alameda Deputy Sheriffs' Assn., et al. v. Alameda County Employees' Retirement Assn, et al.* (2018) 19 Cal.App.5th (***Alameda***), as lead cases.
- *Marin Assn. of Public Employees v. Marin County Employees Retirement Sys*. (2016) 2 Cal. App. 5th 674 (***Marin***), which has the most sweeping Court of Appeal decision, is held for the *Alameda* case. *Cal Fire*, the easiest of the cases, addresses the elimination of air time under PERL. *Alameda* addresses the elimination of various pension spiking mechanisms of the '37 Act.

CHALLENGES TO PEPRA REFORMS

- The Jerry Brown administration weighed in heavily, asking the court in both the *Cal Fire* and *Alameda* cases to hold that prospective benefits are not vested because they have not yet been earned
- The Court decided *Cal Fire* on March 4 of this year. The Court held that air time was not a vested benefit to begin with, and therefore did not address the circumstances under which the benefit could be altered
- The case spawned a significant debate among pension watchers, many of whom viewed the court's refusal to reach the question of when benefits can be changed as a setback. We disagree.

THE CASES THE SUPREME COURT IS CONSIDERING ARE VERY LIMITED

- The cases pending at the Supreme Court involve PEPRA changes as applied to yet-to-be-earned service (prospective service of current employees)

- None of these cases involve changes to “core” benefits such as the pension formula or COLA

- Many of the issues involved in these cases, revolving around the computation of final compensation, have been subject to dispute and change over time

THE TWO MAJOR QUESTIONS IN ALL OF THE CASES

- Are the benefits at issue vested?
- If they are vested, under what circumstances can they be changed?
  - What rationale justifies change?
  - Is it necessary to grant an equivalent benefit?

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CAL FIRE COURT OF APPEAL DECISION

- Two Holdings:
  - Air time is not a vested benefit based upon *REAOC* because no clear legislative intent for benefit to be permanent
  - Even if it was vested, it may be modified prospectively so long as a reasonable and substantial pension remains

THE *CAL FIRE* SUPREME COURT DECISION

- Court declines at the outset to reach the second set of questions concerning how a vested benefit can be changed because it finds the benefit not vested, and therefore, not entitled to constitutional protection at all. However, Court's language in doing so is notable:
  - "The scope of the constitutional protection afforded public pension rights by our prior decisions…has come to be referred to as the 'California Rule,' in part because its breadth has not been widely adopted by other jurisdictions (See, e.g. Monahan…[referring to our doctrine as the 'so-called California Rule' and noting that, of the twelve states to adopt the rule, three have since modified it].)"

THE *CAL FIRE* DECISION

- The Court reaffirms that terms of public employment are generally set by statute and are therefore subject to modification by the legislative body
- While collective bargaining agreements can modify this principle, this generally applies only while the MOU is in effect
- The court recognizes two exceptions: (1) where the legislature clearly intends to create contractual rights; (2) pension rights that constitute deferred compensation.
- The court found no intention by the legislature to create a permanent right to air time

THE *CAL FIRE* DECISION

- Nor could air time be considered deferred compensation because it was not "earned" through service
- At most "air time" was only an offer – employees had the option to accept it by serving 5 years and paying for it
- The mere fact that air time affected pension did not make it a pension benefit for the purpose of vesting law
- CalPERS is not entitled to deference with respect to its publication stating that air time was vested because CalPERS is not charged with constitutional interpretation

CAL FIRE CONTAINS SOME GOOD NEWS

- The Court makes clear that there must be an intellectual justification for vesting benefits. The two potential justifications are "deferred compensation" or a "clear" promise by the legislature that the benefit will continue to be available through retirement
- As deferred compensation will rarely justify a benefit prospectively, the central focus of the court's analysis will be the "promise"
- Some may argue in favor of finding a clear promise regarding "core benefits" (e.g. 3% @ 50), however, most ancillary benefits will probably fail this test
- Examples of ancillary benefits could include various elements of final compensation (e.g. special compensation and premiums), averaging periods for final compensation, contribution rates, COLA, eligibility periods

GOOD NEWS

- The Court utilizes *REAOC*'s language requiring that any promise by the legislature be clear, despite arguments by the plaintiffs that *REAOC* does not apply to pension cases and only applies to implied contracts
- The Court distanced itself from Court of Appeal decisions applying vesting analysis outside the pension sphere:
  - "We have never held …that the constitutional protection afforded pension benefits, which attached even in the absence of manifest legislative intent to create contract rights, extends generally to other benefits of public employment."
  - "We have never held that statutory terms and conditions of employment gain constitutional protection merely from the fact of their existence, even if they have persisted for decades."

GOOD NEWS

- The Court goes on to point out that there are only two cases in which the Court has extended the vesting doctrine outside of pensions, and both involved strong contractual arguments

OPEN ISSUES AFTER *CAL FIRE*

- *Although the Court, at the outset, leaves open the question of under what circumstances a vested benefit can be changed, the big question it leaves open is really the extent to which any as-yet-unearned benefit can be vested absent a clear promise*
- The Court goes out of its way *not* to reaffirm the application of vesting to unearned benefits – and curiously, barely cites the *Eu* case, which is the only case in which the Court expressly held prospective pension benefits are vested at their current level
- This raises the question whether such benefits are vested at all – potentially circumventing the question of how vested benefits can be changed

OPEN ISSUES

- This analysis may circumvent the need to decide how a vested benefit can be changed – as few public agencies assert an already earned benefit can be changed
- And, of course, the question whether a "comparable benefit" is necessary when changing a vested benefit remains an open question.
  - But the question really makes no sense, and the court's treatment of air time is the perfect example

THE FUTURE

- Pension reformers want to know:
  - Can government adopt less generous pension formulas for future service?
  - Can COLAs be reduced – at least for the portion of service credit yet to be earned?
  - Can final compensation be changed more substantially than in PEPRA – e.g. to exclude premiums, extend averaging periods, etc?

- We Could Be Waiting A Long Time For These Answers
  - None of the remaining cases at the Supreme Court address these more fundamental issues
  - Moreover, the cases now pending also may turn on the question whether the benefit features at issue are vested in the first place

THE FUTURE

- At first blush at least, the benefit changes at issue in *Alameda* and *Marin* do not involve clear promises
  - This could have led the Court remand those cases in light of *Cal Fire* – and that is still possible (but unlikely)
  - However, the *Alameda* case has an added complexity because the Court of Appeal found the County was estopped by a prior lawsuit from changing the benefits
- Even if the Court does not remand, it is by no means clear that those cases provide any greater opportunity than *Cal Fire* to address the core of the California Rule

THE FUTURE

- We may need to wait for a test case involving changes to core pension elements prospectively – and, give the makeup of the state legislature, that is unlikely
- That means any change to benefits will most likely come from an initiative or changes to an independent pension plan.
- What we DO know now, is that such an initiative will probably raise an open issue that has yet to be decided by the Supreme Court

The Path Forward:
Addressing Rising Costs

ADDRESSING RISING COSTS

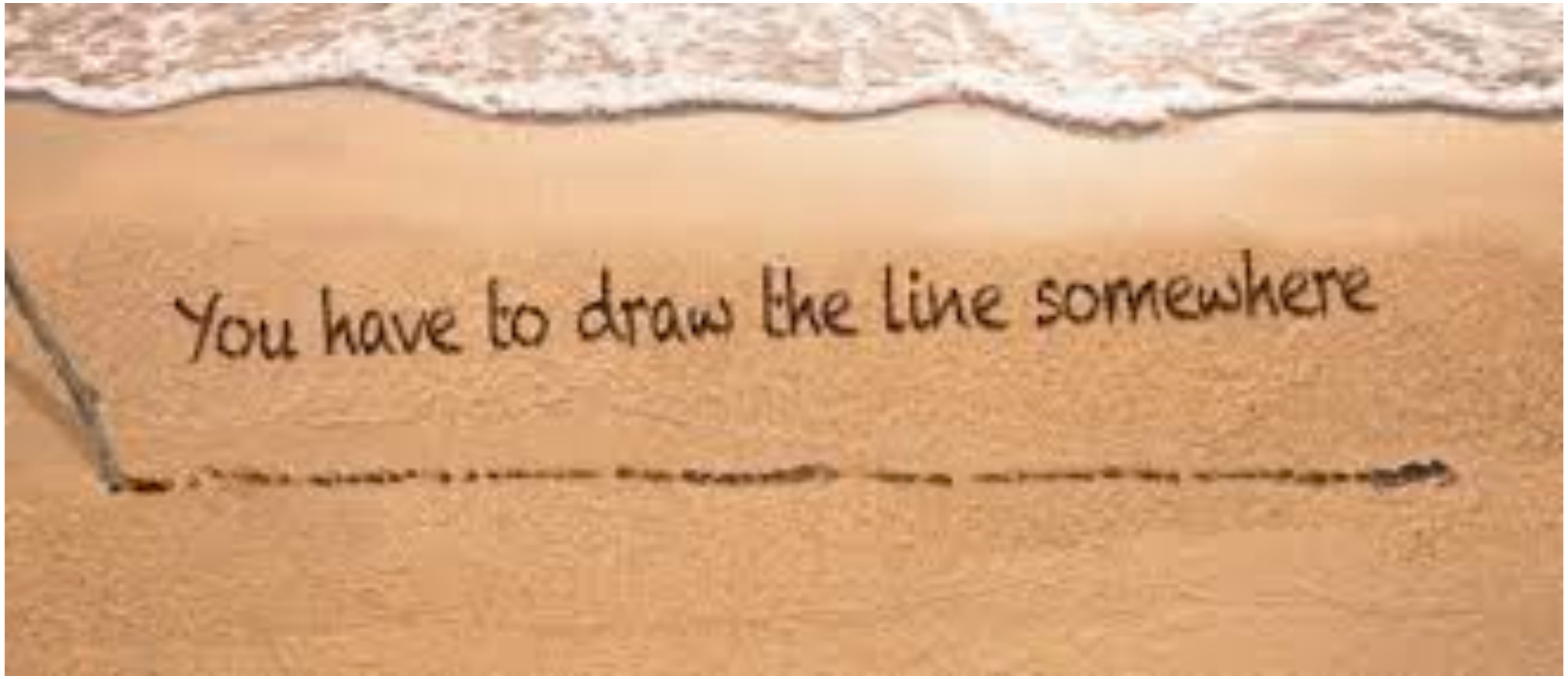
Limited Options:

Under current law, the toughest decisions will be made locally. Each agency will need to make their own decisions on how to use best practices to stabilize their budgets

- Hold the line on wage increases
- Limit pensionable wage
- Contract out
- Shared service models
- Increase employee benefit contributions
- Reduce benefits
- Increase transparency
- Fund benefits
- Bankruptcy

OPTION 5: HOLD THE LINE

1. Is 3 % the right number?



LIMIT PENSIONABLE WAGE

Offer non-pensionable compensation

DEFERRED PAYMENTS

- Pension
- Future Health Care
- 457
- HAS
- VEBA

CURRENT PAYMENTS

- Insurance
  - Health
  - Dental
  - Vision
  - Disability
- Training/Education
- Reimbursements
- Time Off
  - Vacation
  - Holidays (Fixed and Floating)
- Sick
- Longevity
- Administrative

NON – PAY ORIENTED

- Work Schedule
  - City-Wide
    - Alternate (ie. 9/80)
    - 35 hour work week
  - Individual
    - Flexible Work from Home

LIMIT PENSIONABLE WAGE

- But beware: while non-pensionable items are arguably cheaper, employees and potential recruits do not value non-wage items very highly

CONTRACTING OUT

- Public agencies are increasingly contracting out, especially to non-profits. There are many challenges to doing so, however.
  - Independent contractor challenges
  - Meet and confer – decision itself is bargainable if the purpose of contracting out involves cost savings; impact bargainable in any event
  - MOU provisions – many MOUs prohibit or constrain
  - Political challenges
  - Limitations based on *Costa Mesa* for general law cities

SHARED SERVICE MODEL

Address public needs that require regional and/or statewide collaboration.

Simultaneously limit administrative and personnel costs.

- **Shared service models offer a creative way to address public needs while possibly reducing pension obligations.**

INCREASE EMPLOYEE BENEFIT CONTRIBUTIONS

- Increase employee contribution to pension, health and OPEB
  - This may impair total comp. position increasing the risk that you will be paying employees to pay you
    - Old thinking: that's bad because increasing wage to pay for non-pensionable benefits cost money
    - New thinking: new employees are very focused on base wage; increasing base wage does more for recruitment/retention
    - New thinking: pension swap isn't always a bad idea; it increases the wages of newer employees, and typically costs only about half of what a straight wage increase costs

REDUCE NON-PENSION BENEFITS

- Adopt cafeteria plan, reduce retiree medical benefit
- PEMHCA minimum for new employees; establish HRA/HSA
- Second/third tier medical retiree benefits
- Reduce or eliminate CTO, cashouts, in lieu health

INCREASE TRANSPARENCY

1. Make actuarial studies readily accessible
2. Produce summaries of pay and benefits

CITY OF SANTA ROSA
BENEFIT SUMMARY - MISCELLANEOUS UNITS

Revised: January 2016

Employee Group	Operating Engineers, Local 3	Operating Engineers, Local 3	Santa Rosa Employees Association	Santa Rosa Employees Association	Santa Rosa Employees Association	SEIU, Local 1021	SEIU, Local 1021	Santa Rosa City Attorneys Association	Santa Rosa Management Association	Unrepresented	Unrepresented	Unrepresented	Unrepresented	Elected
Approximate Number of Employees	121	56	79	77	262	58	48	6	124	14	19	8	2	7
Item	Unit 3 Maintenance	Unit 16 Utilites Systems Operators	Unit 4 Support Services	Unit 6 Professional	Unit 7 Technical	Unit 8 Transit	Unit 14 Police Civilian Tech.	Unit 17 Professional Attorneys	Unit 18 Misc. Mid-Mgmt	Unit 11 Confidential Mgmt	Unit 12 Confidential	Unit 10 Misc. Executive	Unit 15 Council Appointed	Elected
MOU/Document	7/8/14 - 6/30/16	7/8/14 - 6/30/16	10/7/14 - 7/31/16	10/7/14 - 7/31/16	10/7/14 - 7/31/16	10/1/13 - 6/30/16	7/15/14 - 6/30/16	8/26/14 - 6/30/16	07/15/14 - 6/30/16	11/19/13 - 6/30/16	11/19/13 - 6/30/16	7/15/14 - 6/30/16	Contract	None
Salary														
Last Increase	2.5% 7/2015	2.5% 7/2015	2.29% 7/2015	2.29% 7/2015	2.29% 7/2015	2.5% 7/2015	2.5% 7/2015	4% 7/2015	2.5% 7/2015	2.5% 7/2015	2.5% 7/2015	2.5% 7/2015	2.5% 7/2015	$200 per mo. 7/2007
Next Increase	Unknown	Unknown	2.36% 1/2016	2.36% 1/2016	2.36% 1/2016	1.87% 1/2016	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown
General														
Bilingual Pay	2%	2%	2%	2%	2%	2%	2%	2%	2%	2%	2%	No	No	No
Social Security	No	No	No	No	No	No	No	No	No	No	No	No	No	No
Retirement - PERS Classic Tier I -Employees hired before 7/8/2012; a new hire that was previously employed by the City of Santa Rosa who did not withdraw their member contributions or redeposit the withdrawn contributions within 90 days of rehire. [1]														
Formula	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60	3%@60
Employer Rate - Eff 7/1/14	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%	17.942%
EPMC	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Pension Obligation Bonds	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%	4.300%
Employee Rate	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Employee Cost Sharing	1.50%[1]	1.50%[1]	2.50%[2]	2.50%[2]	2.50%[2]	2.50%[1]	1.50%[1]	1.50%[1]	1.50%[1]	1.50%[1]	1.50%[1]	1.50%[1]	1.50%[1]	0.000
Final Comp	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.	Single Highest yr.

Source: https://srcity.org/DocumentCenter/View/3009/MiscellaneousUnits-Benefit-Matrix-PDF

INCREASE TRANSPARENCY

3. Roll "*gimme*" premiums into bases or eliminate

4. Overtime controls

5. Eliminate cashouts

§115 TRUSTS

ADVANTAGES

- Would be reported as an **asset on balance sheet** (offset to pension and OPEB liabilities)
- Could ultimately increase agency's **bond rating**
- §115 assets subject to greater investment **flexibility** compared to general fund investments

CONCERNS

- Could §115 Trusts lead to **irresponsible investment** choices?
- Labor unrest to the extent funding makes raises difficult

MEET AND CONFER MEETS SECTION 115 PLANS

Issue: Doing this is a good idea, but may trigger an objection or demand to meet and confer to the extent that funding benefits beyond the minimums required depletes funds available for wage increases.

As a general matter, budget decisions (other than those regarding direct employee wages and benefits) are not subject to meet and confer.

BANKRUPTCY

In re City of Stockton, California (Bankr. E.D. Cal. 2015) 526 B.R. 35, aff'd in part, dismissed in part (B.A.P. 9th Cir. 2015) 542 B.R. 261

- The court explained that the law of vested rights did **not** insulate pensions from reduction
- Employee pension payments **can** be reduced as part of a bankruptcy plan

BANKRUPTCY

- It is widely believed that a significant number of older cities will be vulnerable to bankruptcy in the next economic downturn due primarily to CalPERS rate increases. Bartel Associates estimates that the average mature city will be paying 62.3% for safety and 37.9% for non-safety employees by 2024. Cities generally will be paying an average of 15.8% of their total general fund revenues for pension costs alone – about twice the percentage they paid in 2006/2007.
- To avoid this, we anticipate that CalPERS will move more aggressively to establish special rates/processes for distressed cities

THANK YOU!

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