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Public Pensions in California: No More Pension Spiking and Limitations of the California Rule

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Topics

- History – the “California Rule”
- Limits on the Rule
- Two key questions – is it vested, can it be changed
- Recent California Supreme Court decisions
- The Good News
- What is next?



Key Vesting Cases The History

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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 theory of a pension system and its successful operation (*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)



LIMITS ON THE "CALIFORNIA RULE"

REAOC v. County of Orange



- 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.”

The Post-REAOC World

- After the decision in *REAOC*, the question on 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, particularly 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.

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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 it 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.

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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

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Challenges to PEPRA Reforms

- The relatively few provisions of PEPRA affecting existing employees have been challenged judicially.
- The California Supreme Court granted review in a number of cases, but designated and heard 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**), the most sweeping Court of Appeal decision was dismissed by the Supreme Court, after its decision in *Alameda*.

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The Two Major Questions in All of the Cases

1) Are the benefits at issue vested?



2) 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 – Analysis

- 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, and; (2) pension rights that constitute deferred compensation.**

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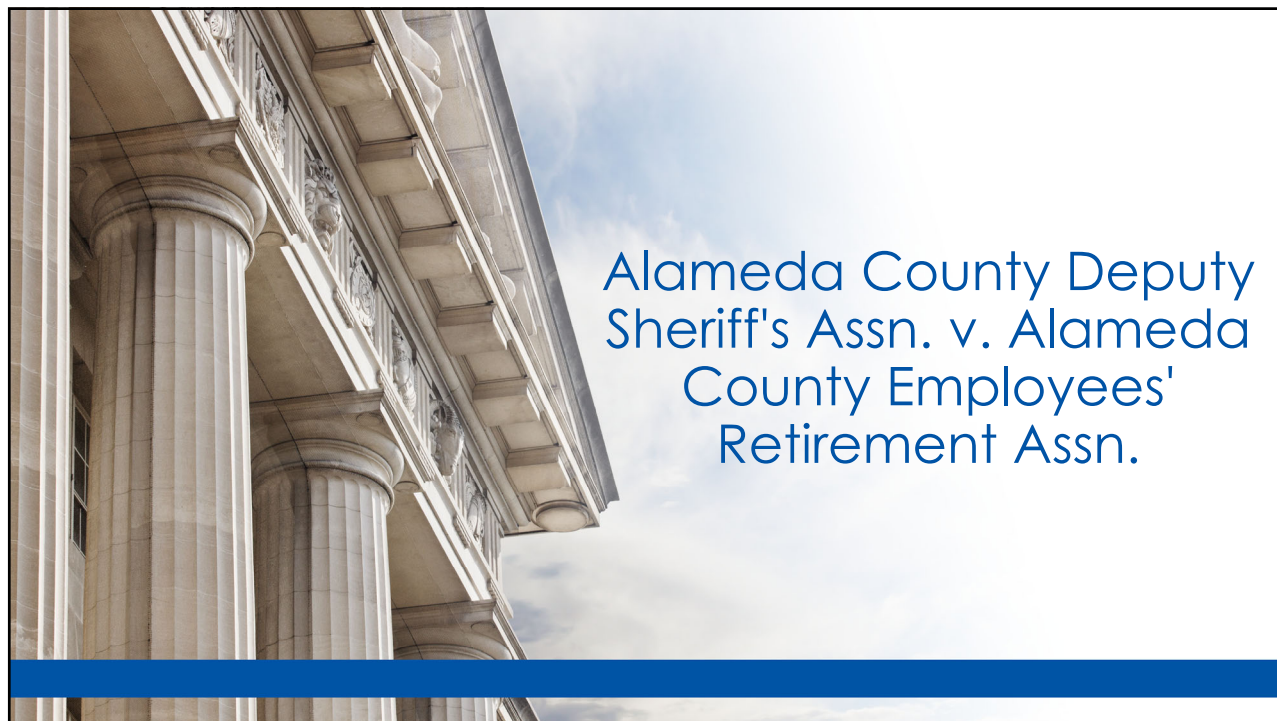
The Cal Fire Decision – Holding

HOLDING:

- The Court found no intention by the legislature to create a permanent right to air time.
- 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.

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- 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."



Pension Spiking

PEPRA eliminates the following pension “spiking” practices for the calculation of compensable earnings in Gov. Code § 31461(b):

- Termination pay — one-time cash payments of unused leave time, paid upon retirement, beyond amounts that would otherwise be earned and payable in the final compensation period.
- Cash outs of vacation or sick pay — beyond the amounts earned and payable in the final compensation period.
- On call pay — pay for additional services performed outside normal working hours.
- Pension enhancements — pay made to enhance a member’s retirement benefit, such as cash paid in lieu of an in-kind benefit, one time or ad hoc payments, and payments paid solely due to termination of employment.

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The Decision

- The Supreme Court disagrees with the Appeal Court and upholds the PEPRA anti-spiking provisions.

HOLDING:

- Because termination pay was not permitted under CERL as pensionable there was never a vested right to it.

HOLDING:

- Although the other three practices prohibited by PEPRA are vested rights, and therefore the California Rule applies, the modifications survive the California Rule.

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The Court: Justification for Change

- For the first time, guidance on what justifies change to a vested benefit
- The Court finds that the PEPPA provisions “bear[s] some material relation to the theory of a pension system and its successful operation”
- Because “[a] **legislative intent to align the express language of a pension statute more closely with its intended manner** of functioning directly relates to both the theory of a pension system and its successful operation.”

The Court: Justification for Change

- The Court explains that “the inclusion in final compensation of the items of compensation excluded or limited by the PEPPA amendment can be viewed as **distorting the pension calculation** and increasing pension benefits beyond the amount anticipated by the underlying theory of compensation earnable.”

The Court: Comparable New Advantage

- The Court rejects the argument that the California Rule always requires a “comparable new advantage.”
- Rather, the Court held that the the California Rule requires only that “the level of pension benefits to be preserved **if it is feasible to do so without undermining the Legislature's permissible purpose** in enacting the pension modification.”

No Comparable Benefit is Required

- The Court acknowledges that PEPRAs does not provide a comparable benefit to the vested rights it removed by prohibiting the spiking practices.
- Because the purpose of the PEPRAs provisions was to ban “spiking” — a practice inconsistent with the intent of CERL — adding a comparable advantage was not required.

The Good News

- The Court added some much-desired substance concerning what are permissible purposes for modifying vested rights, which could be helpful in future cases where modifications are necessary.
- The Court also arguably created a back door in the California Rule by permitting the modifications without including comparable benefits, when doing so would frustrate the permissible modifications.

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More Good News

- The Court noted that a truly “prospective” modification would be one “that applies only to pension rights accrued after its effective date while preserving unchanged the law applicable to pension rights accrued prior to that date.” Although that statement is dicta, tailoring a modification so it applies in this manner is a potential avenue around the California Rule.

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NEW Decisions – Court of Appeal

- Following the Supreme Court decision in *Alameda*, the Court of Appeal further expanded the rationale for modifying pension benefits.
- *Wilmot v. CCCERA* (2021) 60 Cal.App. 5th 631 – Court applied *Alameda* to uphold a new 2013 law, part of PEPRRA, that required limited forfeiture of a public employee's pension if the employee committed a felony related to the employee's public service.
- Same result as in *Hipsher v. LACERS* (2020) 58 Cal.App.5th 671.

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Wilmot - Application of Alameda's 3 Part Test

- 1) PEPRRA forfeiture provision did not include a "compensatory or comparable" advantage to make up with forfeiture.
- 2) But state's purpose was "sufficient for constitutional purposes" - to close a "loophole" because to give convicted felons a pension "would further reward misconduct" related to public service.
- 3) No new comparable advantage required because "why should the Legislature be required to come up with another way to reward criminality by public employees?"

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Takeaways from Wilmot and Hipsher

- The *Alameda* decision is not limited to “pension spiking” but provides a basis to uphold other reforms directed at system loopholes or abuses.
- There is no need for a “comparable new advantage” when inconsistent with purpose of the reform.

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Most Recent Case

- *Nowicki v. CCCERA* (2021) 67 Cal.App.5th 736
- Fire Chief, retired in 2009, did not cause his final compensation to be “improperly increased” (Gov. Code 31539(a)(2).)
- Based on Supreme Court decision in *Alameda Sheriffs* (2020)
- Because *Alameda* decision held that in 2009, pre-PEPRA, spiking practices used by Chief were not illegal.

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The Future of Pension Reform Remains Uncertain



- We may need to wait for a test case involving changes to core pension elements prospectively — however, given 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 is that such an initiative will probably raise an open issue that has yet to be decided by the Supreme Court.

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The background of the slide features a photograph of a classical building facade with several large, white, fluted columns and ornate architectural details. The sky is visible in the background, showing some clouds.The RPLG logo is centered in the upper right portion of the slide. It features the letters "RPLG" in a large, white, bold, sans-serif font within a blue rectangular box. Below the box, the text "Renne Public Law Group" is written in a smaller, blue, sans-serif font.

Thank You!

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