California Supreme Court Upholds "California Rule" and 2013 Pension "Reform" Statutes, Setting the Stage for More Retirement System Governance Challenges

By: Ashley Dunning and Peter Mixon

In 2012, the California legislature enacted changes to the statutes governing the calculation of benefits paid by state and local pension plans—the Public Employees' Pension Reform Act of 2013 ("PEPRA"). Many of these changes only applied to "new members" – those individuals who first became plan members after PEPRA's enactment. PEPRA also, however, amended the definition of "compensation earnable" in the County Employees Retirement Law of 1937 ("CERL"), which is used to calculate retirement allowances of members of 20 CERL retirement systems. These CERL changes applied to all members who had not yet retired as of PEPRA's effective date of January 1, 2013. These amendments specified new exclusions from the compensation earnable definition ("PEPRA Exclusions") and therefore reduced affected members' future anticipated retirement allowances. Several of the CERL systems applied the PEPRA Exclusions to members who retired on or after January 1, 2013.

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Lawsuits were filed against four such systems, challenging the constitutionality of the PEPRA Exclusions, as well as the authority of retirement boards to implement them given prior promises (by resolutions and settlement agreements) to include pay in retirement allowances that constitute PEPRA Exclusions. Three of those cases were consolidated, and in 2018, a court of appeal issued the decision in *Alameda Sheriffs*, which would have prevented those three systems from implementing the PEPRA Exclusions. The fourth case, however, proceeded separately, and the court of appeal decision rendered in that case upheld the constitutionality of the PEPRA Exclusions and affirmed the system's implementation of them. The California Supreme Court accepted petitions for review in all four cases and designated *Alameda Sheriffs* as the "lead" case.

On July 30 of this year, the California Supreme Court issued a unanimous decision in the lead case, *Alameda County Deputy Sheriff's Assoc. et al., v. Alameda County Employees' Retirement Assn., et al.* (2020) 9 Cal.5th 103 (*"Alameda"*). *Alameda* is a milestone in the caselaw defining the vested pension rights of public employees in California. First, the *Alameda* Court decided the narrow issue presented to it, determining that the PEPRA Exclusions were constitutional, while preserving the California Rule, which protects the contractual rights of current active and deferred retirement system members to a pension calculated under the basic statutory terms in effect at the time of their employment. Despite academic and legal criticism of the California Rule, the Court rejected arguments that it should be substantially scaled back or eliminated altogether. While affirming the fundamental tenets of the California Rule, the Court's decision refocuses the judicial review applied to benefit changes. For those alterations that disadvantage current system members who have not yet retired, courts will now closely examine the stated purposes of such modifications to determine whether they are justified and thus permissible under the contract clause of the California Constitution. The Court also reviewed the scope of authority granted to county retirement boards to interpret and implement retirement plan statutes. Reaffirming their role as public agency administrators who interpret such statutes in the first instance, the Court rejected claims brought against these boards based on estoppel and written contracts, reaffirming that retirement boards have no authority to "evade" the law.

In *Alameda*, the Court first noted its recent decision on another PEPRA change – the elimination of members' right to purchase additional retirement service credit ("ARS"). In that case, *Cal Fire Local 2881 v. California Public Employees' Retirement System* (2019) 6 Cal.5th 965 (*"CalFIRE"*), the Court examined ARS to determine whether it created a "vested" constitutionally protected contract right. The *CalFIRE* Court unanimously concluded that "California's public employees have never had a contractual right to the continued availability of the opportunity to purchase [ARS] credit." (*CalFIRE*, 6 Cal.5th at p. 993.) Accordingly, the Court stated that its decision "expresses no opinion on the various issues raised by the state and amici curiae relating to the scope of the California Rule."

The *Alameda* Court then turned to the issue left unaddressed in *CalFIRE*: whether PEPRA's amendments to the compensation earnable definition violated the rights of county employees under the contract clause of the California Constitution. Under the California Rule, a public employee has a contractual right to continue accruing retirement benefits on the same or better

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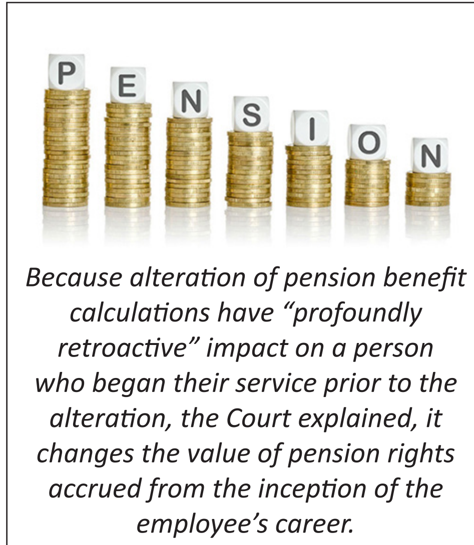
terms during the entire tenure of their employment. The California Rule, also adopted in a number of other states, is premised on the view that retirement benefits provided through legislation or similar governmental action are a form of deferred compensation promised by the employer and thus are part of the employee's employment contract. These retirement benefit rights are protected by the contract clause and, under decades of caselaw, may not be impaired through changes detrimental to the member unless accompanied by corresponding benefits.

The Court discussed the half-century judicial history of the California Rule at length and mainly affirmed it, observing that from its first articulation of the rule in *Allen v. City of Long Beach* (1955) 45 Cal.2d 128 ("*Allen I*"), through "the intervening 65 years, our decisions have clarified aspects of the *Allen I* test, but its substance is unchanged." The Court synthesized these decisions into a two-part test. A court must "first … determine whether the modifications impose an economic disadvantage on affected employees and, if so, whether those disadvantages are offset in some manner by comparable new advantages." If the modifications result in disadvantages, "[t]he court must then determine whether the government's articulated purpose was sufficient, for constitutional purposes, to justify any impairment of pension rights." (*Alameda*, 9 Cal.5th at p. 1082.)



Because alteration of pension benefit calculations have "profoundly retroactive" impact on a person who began their service prior to the alteration, the Court explained, it changes the value of pension rights accrued from the inception of the employee's career.

This summation of the California Rule is clearly consistent with prior California Rule caselaw. On one hotly contested point, however, the Court sided with three lower courts of appeals in holding that when a change in law results in disadvantages to employees, it "should," and not "must," be accompanied by "comparable new advantages." (*Id.* at pp. 1083-1084.) On its face, this is arguably a change to the strictures of the California Rule. But the Court appeared to limit its application through its review of prior caselaw and the types of "permissible purposes" that justify a disadvantageous change in a statute that creates a protected contract right.

The Court also addressed the argument that the PEPRA changes did not violate the contract clause because these changes only operated "prospectively," that is, to future determinations of retirement allowances for those who have not yet retired. According to the State of California, these statutory changes did not implicate contract rights because they applied only to retirements occurring, or potentially even earnings received, after the effective date of the legislation. In other words, if compensation earnable were determined as to post-January 1, 2013 time periods, the legislation did not "retroactively" re-characterize the pensionability of any pay item and thus operated only on a prospective basis. The State argued that this prospective operation insulates the changes from constitutional scrutiny. (*Id.* at p. 1090.)

The Court rejected this argument as applied to all PEPRA Exclusions other than termination pay (which it deemed to be consistent with prior case law), noting that it "disregard[s]" the Court's "long-standing contract clause jurisprudence" when applied to changes in the manner in which already accrued retirement allowances are calculated. More fundamentally, the Court held, "it misunderstands the impact of prospective application[.]" Because alteration of pension benefit calculations have "profoundly retroactive" impact on a person who began their service prior to the alteration, the Court explained, it changes the value of pension rights accrued from the inception of the employee's career.

For these reasons, the Court concluded, the State's argument that the PEPRA amendments operate prospectively only, and thus do not implicate the contracts clause, is "misguided." Instead, a truly "prospective" pension modification would apply only to pension rights *accrued* after the effective date. This was not the effect of the PEPRA provisions at issue. (*Id.* at pp. 1091-1092.) In a footnote, the Court stated, "we do not mean to suggest that a change that is prospective in practice would thereby be insulated from contract clause scrutiny under *Allen I*." (*Id.* at p. 1092 fn.29.) Thus, the Court left the issue of a truly "prospective" change for another day.

Returning to the legislation at issue and noting its earlier decision interpreting the "compensation earnable" statute in *Ventura County Deputy Sheriffs' Assn. v. Board of Retirement* (1997) 16 Cal.4th 483, 499 ("*Ventura County*"), the Court concluded that because PEPRA excluded certain pay items from compensation earnable that *Ventura County* appeared to include, the PEPRA Exclusions "constituted a modification of CERL," as to all but "termination pay." Because the PEPRA Exclusions resulted in

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smaller pensions to some than *Ventura's* interpretation of the pre-PEPRA version of the statute would have required, and did not provide a "comparable new advantage," the Court held that these changes were sufficient to meet the "first component" of the California Rule. (*Id*. at pp. 1088-1089.)

The Court then turned to the second component: in order to be constitutional, changes to a public pension must be enacted for a constitutionally permissible purpose. Observing that "public employee pension plans may be modified 'to maintain the integrity of the system in accord with changing conditions,' in order to survive contract clause scrutiny such changes must bear some material relation to the theory of a pension system and its successful operation." (*Id*. at p. 1077.) The Court then concluded, "assuming the changes were made for a proper purpose, one further analytic step is necessary …: The Legislature's decision to impose financial disadvantages on public employees without providing comparable advantages will be upheld under the contract clause only if providing comparable advantages would undermine, or would otherwise be inconsistent with, the modification's constitutionally permissible purpose." Here, the Court "conclude[d] that the PEPRA amendment survives this constitutional scrutiny." (*Id*. at p. 1093.)

As the Court stated, "PEPRA's amendments of CERL were enacted for the constitutionally permissible purpose of conforming pension benefits more closely to the theory underlying [the compensation earnable definition] by closing loopholes and proscribing potentially abusive practices." "Unquestionably," the Court explained, "preventing manipulation of the terms of a pension plan to produce outsize benefits is a substantively proper reason for modifying the plan, since it serves to maintain the system's financial integrity and discourage gamesmanship in the management of compensation practices."[1]

The Court then ventured into new territory: "[T]he contract clause requires a properly motivated pension modification to provide comparable new advantages to offset any financial disadvantages unless to do so would undermine, or would otherwise be inconsistent with, the constitutionally permissible purpose underlying the modification." The Court held that "the PEPRA amendment at issue here is constitutional under this analysis." (*Id*. at p. 1099.) In conclusion, the Court rejected arguments that the California Rule constitutes an improper interpretation of the contract clause: "[W]e have no jurisprudential reason to undertake a fundamental reexamination of the [California] [R]ule. The test announced in *Allen I*, as explained and applied here, remains the law in California."

The *Alameda* Court also rejected claims that settlement agreements or other actions taken by retirement boards before PEPRA created contractual or equitable rights to continue to receive the benefit of those promises when the benefits were no longer permitted by statute. "[N]either argument authorizes the county retirement boards to administer [pension laws] in a manner inconsistent with the governing statutory provisions by including items of compensation in compensation earnable that section 31461, as amended, excludes." (*Id*. at pp. 1066-1067.) For this reason, the Court disapproved prior caselaw suggesting that CERL boards have the authority to include pay items in compensation earnable that the CERL does not permit.

Finally, the Court addressed, at least indirectly, important issues of public retirement system governance: the correction of errors and improvement of system operations. *Alameda* confirms that boards have the authority to correct retirement system errors and improve retirement system operations, without being bound by estoppel principles to perpetuate erroneous construction of statutes. Significantly, those two principles become even more important as CERL retirement boards that have not yet implemented the PEPRA Exclusions because of the pending litigation now do so. CERL systems will face the challenge of applying PEPRA Exclusions to CERL system members who have been retired for up to seven years, as well as other previously unenforced statutory exclusions to CERL system members who retire on and after the *Alameda* decision was rendered on July 30, 2020.

The California Constitution expressly affords public retirement boards "plenary authority, consistent with their fiduciary responsibilities," to administer the retirement systems they govern. This grant of authority enables boards to correct system errors and improve operations after carefully balancing the short and long-term interests of their members. The Supreme Court's guidance on this topic provides critical confirmation of that aspect of public retirement system governance in California, while also confirming the significance of the California Rule to the administration of public retirements. How these principles play out in action will be the next chapter in this story.

__Ashley Dunning__ and __Peter Mixon__ are both Partners at Nossaman.

ENDNOTE:

[1]The Court also described *non*-permissible purposes including "essentially political reasons," such as responding to "the objections of taxpayers" and "an attempt to stem rising pensions costs[.]" (*Id*. at pp. 1094-1095.)

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