PERS' Path Forward: Risks, Opportunities and Options

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Notes:

Presentation: "The PERS Path Forward: Risks, Opportunities, and Options"

WHY THE CONVENTIONAL UNDERSTANDING OF THE "CALIFORNIA RULE" ON PENSION VESTING IS ALL WRONG

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I. AUTHORS' NOTE

The central issue Mary Beth and I will address in our talk is the problem on which most California cities are spending a lot of their time these days: how to deal with huge increases in CalPERS pension costs. In our presentation, we will discuss the very limited options available to cities to address both the known, and as yet unknown increases in PERS contribution rates.

A key part of that discussion is whether there will be any relief from the California Supreme Court in the area of vested rights – perhaps creating opportunities to reduce pension costs for current employees, not just new employees. The California Supreme Court is now considering three cases that touch on this issue – *Cal Fire Local 2881 v. California Public Employees' Retirement System* (2016) 7 Cal.App.5th 115 (*Cal Fire*), *Alameda County Deputy Sheriff's Association et al. v. Alameda County Employees' Retirement Association, et al.* (2018) 19 Cal.App.5th 61 (*Alameda*), and *Marin Association of Public Employees' Retirement Association* (2016) 2 Cal.App.5th 674 (*Marin*) .

All three cases stem from changes to pension plans affecting current employees; all three cases involve changes that occurred as a result of PEPRA. The cases involve "ancillary" benefits such as the elimination of "air time," pensionability of cash outs, and other issues related to pension spiking. All of these changes can be loosely described as elimination of practices that are antithetical to good pension administration. None of the cases directly address whether the legislature, for example, could require current employees to go into the new, leaner, pension tiers that were created by PEPRA. Hence, the decisions in these cases are unlikely to tell us whether such wholesale changes would pass constitutional muster, even if the legislature were willing to enact such legislation.

However, there is a reasonably good chance the Court may take a new look at the so called "California Rule," and provide some guidance on when changes to benefits for current employees are permissible – a standard that will at least tell us what kinds of legislative changes may be acceptable.

The authors of this paper prepared the League's Amicus Brief in the lead case before the Supreme Court – Cal Fire – and represent a party in the Alameda case. This article is based generally on the brief we submitted in Cal Fire. Although we have worked on vesting-related issues for decades, writing the brief over a number of months gave us an opportunity to do a deeper dive into the so called California rule. In the process, we gained a fuller appreciation of why the purported rule *cannot* be a correct statement of law. In this paper, we hope to take you on part of our journey.

II. INTRODUCTION

Much has changed since the California Supreme Court last visited the question of when a "vested" retirement benefit may be altered. The unfunded liabilities of pension plans have soared, and are now at levels that barely cover the liabilities for those who have already retired. Employer pension costs have increased rapidly, and are anticipated to grow by another fifty percent, in some cases doubling, in the next few years. Employee contributions to pensions, intended to pay half of pension costs, now cover less than one fifth of the cost in many cases. Public sector collective bargaining has blossomed, but is handicapped by the assumption that pension modification, even for prospective service, cannot be on the table.

Contrary to conventional wisdom, if pension modification is not adequately addressed, the risk is not to the pension systems. Rather, it is to retirees and to the public. If cities cannot make their pension contributions, it is the retirees who will face harsh consequences as CalPERS will cut their pensions. Additionally, federal courts have found that pension vesting rules provide no immunity from reducing pensions in bankruptcy. As for the tax-paying public, the pension crisis has resulted in the "hollowing out" of city services, with parks, libraries, after-school programs and social services often being the first to go, and police and fire services following. Even cities that are technically solvent have become "service insolvent," unable to afford the basic services they were created to provide.

In the cases before it, we hope the Court will address a number of pivotal issues:

The "unmistakability" doctrine. In *Retired Employees Association Of Orange County, Inc. v. County of Orange* (2011) 52 Cal.4th 1171, 1186-1197 (*REAOC*), the California Supreme Court confirmed that there must be "clear and convincing" evidence of legislative intent to create a vested right. *REAOC* is in accord with many other federal and state courts that have required "unmistakable" evidence before finding that a legislative body has relinquished its constitutional power to modify legislation. In our brief, we have asked the Court to confirm that the unmistakability doctrine must be rigorously applied, and reject the unions' contentions that it does not apply to pension benefits or applies only to "implied" benefits.

Prospective versus retrospective vesting. It is possible that the court may decide the cases before it by concluding, based on the unmistakability doctrine, that the benefits at issue were not vested, and decline to reach the more important issue of the “California rule.” The State, the League and other amici, have urged the Court to follow the lead of the appellate courts that have addressed the broader issue, attempting to make sense of the concept of “vesting” as applied to benefits for future service not yet rendered. In *Cal Fire* and in in *Marin Association of Public Employees v. Marin County Employees’ Retirement* the Courts of Appeal based their conclusions that the pension benefit modifications at issue did not violate the Contracts Clause in part on the fact that the changes to current employees’ benefits operated only prospectively.

Pension benefits have long been characterized as a form of “deferred compensation.” As with other forms of compensation, there is a high bar to changing pension benefits attached to time already worked. However, for benefits attached to time not yet worked, there must be a different standard, because the benefits have not yet been earned.

Courts nationwide recognize this distinction. The California Supreme Court too has repeatedly stated that, for active employees, “reasonable” modifications may be made “before the pension becomes payable” and until then “the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension.” (E.g., *Miller v. State of California* (1977) 18 Cal.3d 808, 816.) However, some parties have argued, based upon dicta in a number of decisions before and after *Miller*, that this flexibility is for all practical purposes illusory.

“Comparative advantage” for every disadvantage. In their briefing in Cal Fire, the unions predictably contend that for every disadvantageous change to a pension benefit, an equivalent advantageous change “must” be granted. In practice this argument would prevent any correction of past abuses or unforeseen burdens. To the extent that a change is based upon an abuse or unanticipated burden, it simply makes no sense to require the benefit be replaced by an equivalent benefit. The standard is self-cancelling: changes to benefits for prospective service can be made, but only if each and every person affected is made whole, meaning the change is illusory.

Three appellate courts, including the Courts of Appeal in *Cal Fire*, *Alameda* and *Marin*, have now recognized this “strait jacket” and held that under this Court’s jurisprudence, an equivalent “should” be granted, but is not always required. The State, the League and other amici agree that whether an “equivalent benefit” is granted is only one of a number of factors that should be considered in determining whether a change to a benefit for prospective service is reasonable.

Unforeseen advantages and burdens. A benefit that is offered when an employee first comes to work, and potentially lasts until they die, will be subject to changing conditions. There is a significant benefit to both employee and employer to modifying these benefits for future service yet to be rendered. Modification protects critical public services, allowing a city to continue employing workers; it protects the ability to pay benefits that employees have already earned; and it protects retirees whose pensions could be threatened by city insolvency. The contrary rigid position leaves no room for these countervailing advantages rooted in sound public policy.

The California Supreme Court has long held that vested benefits, particularly for service not yet rendered, "may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system." (*Betts v. Board of Admin.* (1978) 21 Cal.3d 859, 863.) "Constitutional decisions 'have never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change.'" (*Allen v. Board of Admin. Of the Public Employees' Retirement System* (1983) 34 Cal.3d 114, 120, [citations omitted].)

Based on the above and existing case law, our brief suggested a number of criteria that courts should consider, on a case-by-case basis, when considering whether a "vested" benefit may be diminished:

- Whether the modification affects only service yet to be rendered, or service already rendered. Modification of benefits tied to future service is subject to a lesser standard because they have not yet been earned.

- The extent of the modification. This factor includes whether the benefit change is to an ancillary benefit, such as air-time, or a more central component of the pension scheme. The lesser the modification, the more latitude the legislature and local legislative bodies have in making changes. Modifications are permitted so long as a "substantial and reasonable" pension remains.

- The public policies to be served. Whether the modification bears "a material relation to the theory of a pension system and its successful operation…." This includes the need to adapt to changing conditions, in order to protect against abuses that have arisen or burdens that were unforeseen. Tying the hands of government for nearly a century based on outdated assumptions proven incorrect over time endangers both the public and the rights of employees who have completed the pension bargain through their service.

III. BACKGROUND

A. California's Cities Are Facing An Unprecedented Financial Crisis Due To The Unsustainable Rise In Pension And Retiree Health Costs

Seven years ago, the Little Hoover Commission sounded the alarm. In an oft-quoted sentence, the Commission reported: "California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently." (Little Hoover Commission, Public Pensions For Retirement Security, February 2011 ("Little Hoover Report").)

The Report demonstrated that, "[t]he 10 largest pension systems in California – encompassing 90 percent of all assets and members in the state's defined benefit systems – faced a combined shortfall of more than $240 billion in 2010." (Little Hoover Report at ii.)[1] These systems were only 58% to 74% funded, when an 80% funded status "is considered the low threshold for a stable system." (*Ibid*.)

The Report found that "pension costs will crush government. "Government budgets are being cut while pension costs continue to rise and squeeze other government priorities." (*Id*. at iii.)

B. Public Employers, Such As Cities, Bear The Cost Of Pension Unfunded Liabilities.

The state has 85 "defined-benefit" plans, including six state plans, 21 county plans, 32 city plans and 26 specific district and other plans. (Little Hoover Report at 4.)[2]

The largest plan, indeed the largest pension plan in the nation, is the California Public Employees' Retirement System ("CalPERS"). Although most California cities are members of CalPERS, some cities, including Los Angeles, San Francisco and San Jose, manage their own pension funds. (*Ibid*.)

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[1] See also, "The Pension Gap," Los Angeles Times, September 18, 2016.

[2] CalPERS includes all state workers, some university employees, judges, some legislators, and public agencies and school districts who contract with CalPERS. (Little Hoover Report at 4.) The California State Teachers' Retirement System ("CalSTRS") is the nation's second largest pension system. (*Ibid*.) Under the County Employees' Retirement Law ("CERL"), 20 counties operate retirement plans independent of CalPERS. (*Id*. at 5.) The University of California operates its own pension system. (*Ibid*.)

Typically pension systems are governed by a board of officials, some elected by employees and retirees and others appointed by government bodies. The retirement boards manage the fund investments and, with the assistance of actuaries, set the amounts that employers must contribute to the system. (*Ibid.*)

Pension contributions are charged as a percentage of payroll. Typically, public *employee* contributions are limited by statute or cover only the employee's share of "normal cost" which is the cost for the current year. Public *employer* contributions, on the other hand, are potentially unlimited, because employers are responsible for not only the employer share of "normal cost" but also the total cost of any "unfunded liabilities."

As a result, public employers, and thus taxpayers, are the guarantors of pensions. In a typical example, employees pay only 11% of their salaries towards their pensions (the normal cost), whereas the city, because it pays for both normal cost and unfunded liabilities, pays 61% of payroll -- in other words an additional $61 for every $100 in salary.

C. Since The Little Hoover Commission 2011 Report, City Pension Costs Have Skyrocketed

In 2011, the Little Hoover Commission stated that: "In another five years, when pension contributions from government are expected to jump 40 to 80 percent and remain at those levels for decades … there will be no debate about the magnitude of the problem." (Little Hoover Report at 22.) It stated:

> Across the state, governments will be forced to sacrifice schools, public safety, libraries, parks, roads and social services – core functions of government – and the public jobs that go with them, to pay the benefits that have been overpromised to current workers and retirees.

(*Id*. at 43.) That prediction has come true.

CalPERS is only 68% funded.[3] Based on recent rate hikes, local government employers owe CalPERS $5.3 billion this year, and that amount will almost double to $10.1 billion in 2024." ("California Pension Contributions to Double by 2024 – Best Case," California Policy Center, Jan. 31, 2018.) Statewide, the public employer contribution "will double, from $31 billion in 2018 to $59 billion by 2024." (*Ibid.*)

For example, in late 2016, the Los Angeles Times reported that Los Angeles's "general fund payments for pensions and retiree healthcare reached $1.04 billion last

[3] See CalPERS 2016-2017 Comprehensive Annual Financial Report For Fiscal Year Ending June 30, 2017, p. 4.

year, eating up more than 20% of operating revenue – compared with less than 5% in 2002." ("Paying for public retirees has never cost L.A. taxpayers more. And that's after pension reform," Los Angeles Times, November 18, 2016.)

Los Angeles is not alone. "L.A.'s pension burden, while severe by national standards, is not unusual for California. Six of the state's 10 largest cities – Los Angeles, San Diego, San Jose, Sacramento, Oakland and Bakersfield – devoted more than 15% of their general fund budgets to pensions and retiree healthcare during the 2015 fiscal year, The Times found. San Jose contributed the greatest share – almost 28%." (*Ibid*.)[4]

The Times also looked at the City of Richmond, where payments for employee pensions and retiree healthcare "have climbed from $25 million to $44 million in the last five years, outpacing all other expenses." ("Cutting jobs, street repairs, library books to keep up with pension costs," Los Angeles Times, February 6, 2017.)

The Times concluded: "Richmond is a stark example of how pension costs are causing fiscal stress in cities across California." The Times noted that municipalities, including Vallejo, Stockton, and San Bernardino had filed for bankruptcy. (*Ibid*.)

D. California Cities Are Facing Increases In Pension Costs That They Cannot Meet Without Cutting Vital City Services, Or Even Becoming Insolvent

In 2017, the League of California Cities commissioned an actuarial study to address the impact of increased CalPERS contributions on the League's members ("Retirement System Sustainability, A Secure Future For California Cities," League of California Cities Retirement System Sustainability Study and Initial Findings, January 2018) (http://www.cacities.org/pensions ("League Study").)[5] My co-presenter, Mary Beth Redding from Bartel and Associates was the lead researcher. The Study reported as follows:

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[4] According to the Times, the percentages of the general fund during 2014-2015 (spent on pensions and retiree health benefits) are as follows: San Jose (27.86%), Oakland (20.78%), Los Angeles (20.70%), Bakersfield (10.46%), San Diego (19.30%), Sacramento (17.38%), Anaheim (13.11%), Fresno (12.15%), Long Beach (11.62%), San Francisco (8.13%).

[5] The League study analyzes cities who are members of CalPERS, and does not include those with their own pension systems, such as Los Angeles, San Jose or San Francisco. However, like members of CalPERS, those cities, as demonstrated by the Los Angeles Times articles cited above, are being required to devote an unsustainable percentage of their general fund resources to retirement costs.

1. City pension costs are dramatically increasing to unsustainable levels

According to the League Study, between fiscal years 2018-19 and 2024-25, cities' dollar contributions for annual pension costs will increase more than 50%. For example, if a city will pay $5 million in 2018-19 then the city is expected to pay more than $7.5 million in 2024-25. (League Study at 2; and Slides 18 & 19.)

By fiscal year 2024-25, the average projected city contribution rate is 34.6% of salary for miscellaneous employees and 60.2% for safety (police officers and fire fighters) employees. This means for every $100 in pensionable wages for miscellaneous employees, cities would pay on average *an additional* $34.60 to CalPERS for pensions alone. For every $100 in pensionable wages for safety employees, cities would pay on average *an additional* $60.20 to CalPERS for pensions alone. These amounts do not include the costs of retiree health care. (League Study at 2, 3, Slide 20.)

2. Rising pension costs will require Cities to nearly double the percentage of their general fund dollars they pay to CalPERS

As part of its study, the League surveyed its members, asking what portion of City general fund budgets were devoted to paying pension costs to CalPERS. These percentages are for CalPERS costs only, over and above the cost of salaries – and do not include the cost of retiree healthcare.

The League Study concluded that in fiscal year 2006-07, the average city spent 8.3% of its general fund budget on CalPERS pension costs, but that average increased to 11.2% in fiscal year 2017-18, and is anticipated to increase to 15.8% in fiscal year 2024/2025. (League Study at 4, and Slide 33.)

In fiscal year 2024-25, 25% of cities are anticipated to spend more than 18% of their general fund budget on CalPERS pension costs with 10% of those cities anticipated to spend 21.5% or more. (League Study at 4 and Slide 33.) These cities are located all over the state. (League Study at 4, and Slides 34, 35, 36.)

Cities are limited in their ability to raise revenue and by law must balance their annual budgets. (Cal. Const., art. XVI, sec. 18.) Accordingly, as pension contributions rise, local agencies are forced to reduce or eliminate critical programs such as fire protection, law enforcement, parks services, and other municipal services.

3. Snapshots Of Individual Cities Tell The Story

The overall statistics are dire, but the plight of individual cities brings them to life.

The City of Corona recently wrote CalPERS to seek help in meeting its pension obligations. Since 2003, the City's annual employer contribution to CalPERS increased from $5.5 million to $23.8 million, more than 300%, with an expected increase to $40.3 million in the next seven years. The City reported it was "on a path to insolvency" with its reserves depleted by fiscal year 2020-21. Already Corona has cut 28% of its workforce, including police and fire personnel, and must make additional cuts "across the City including Fire, Police and Parks and Recreation." (Letter to Rob Feckner, President, CalPERS Board of Administration, from City of Corona, November 10, 2017.)

The California Policy Center recently published a list of the cities that would be hit hardest by CalPERS rate hikes. ("How Much More Will Cities and Counties Pay CalPERS?" California Policy Center, January 10, 2018.) For the city that topped the list, the Policy Center concluded that by 2024, for every dollar the city paid active employees in wages, the city "will have to contribute 89 cents to CalPERS" and in just six years, the city's "payment on its unfunded liability will increase by 99%, from $2.9 million today to $5.8 million in 2024." (*Ibid.*)

In a case study that included six cities, the Stanford Institute For Economic Policy Research (SIEPR) demonstrated that spending on pension obligations is "crowding out" spending on vital city services. ("Pension Math: Public Pension Spending and Service Crowd Out in California, 2003-2030," Stanford Institute for Economic Policy Research, October 2, 2017, at 75, 84-85.) For example, the study concluded that in the City of Vallejo, the number of police officers had fallen from 221 in 2005 to 143 in 2014, the number of fire personnel had fallen 30% in the same time period, and projected pension increases would require an additional 24% reduction in police and fire expenditures. (*Id*. at 59.)

4. The Factors Driving Current Costs Were Not Anticipated When Increased Benefits Were Granted

The escalating costs of pensions are due to many changes in assumptions that were not known when the pensions were originally offered. For example, the 3% @ 50 benefit formula for public safety employees was first made available in 2000.[6] At the time, CalPERS asserted that the benefit would have no cost to employers because the plans were super-funded. (Little Hoover Report at 13.) That assumption turned out to be wrong for a number of reasons.

First, people are living longer, so actuarial mortality tables needed to be adjusted to reflect a longer pay-out period for pensions. Second, markets lost an enormous amount of their value due to recessions in 2001 and 2008 that were far more severe and prolonged than all but a few expected. Third, it appears that investment returns, even after the recession, will not live up to the assumptions accepted at the time (8% annual growth). And fourth, retirees now outnumber active employees, in part because the number of public employees has not grown at nearly the rate it had previously, and because the baby-boomers are aging but living longer. As a result, pension systems have developed large unfunded liabilities, which in turn have resulted in higher costs for public employers. (Little Hoover Report at 25-28).

These kinds of changes have occurred over only the last twenty years. One can only imagine how many more changes will occur over the next fifty years that will affect the viability of pensions being offered today.

IV. HOW TO RECTIFY THE POPULAR MISCONCEPTION OF THE "CALIFORNIA RULE" ON PENSION MODIFICATION.

A. In California, The Law Of Vested Rights Is Judge Made Law That Must Be Clarified As Circumstances Change and Evolve

The California constitution's contracts clause prohibits the legislature from enacting any "law impairing the obligation of contracts." (Cal. Const., art. I, § 9.) The constitution says nothing about public employee pensions. Rather, the application of the contracts clause to pensions has evolved through constitutional interpretation – as developed by the Supreme Court and the lower appellate courts.

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[6] In 1999, AB 400 authorized state and local agencies to offer the 3% @ 50 pension formula for safety personnel. Under this formula, safety personnel such as police officers and fire fighters received a pension benefit calculated by multiplying 3% x number of years worked x final salary, up to 90% of their final salary. The Little Hoover Commission reported "The changes were allowed to be applied retroactively, putting in motion a bidding war among government agencies, particularly at the local level, to retain and attract talent by boosting retirement benefits." (Report at 13.) "In 2001, the Legislature passed AB 616, allowing local agencies to increase pension formulas for miscellaneous employees to as high as 3 percent at 60, sparking another bidding war." (*Id*. at 14.)

Decades ago, a pension was characterized as a mere “gratuity” that could be withdrawn at will.[7] Over time, courts across the country rejected that concept, and looked for an alternative that more accurately reflected the reality that employees worked not only for current wages, but for “deferred compensation” in the form of a pension.

But courts also acknowledged that public employers must have flexibility in dealing with these long-term obligations. As stated in *Kern*: “The rule permitting modification of pensions is a necessary one since pension systems must be kept flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy.” (29 Cal.2d at 855.)

This flexibility, however, has been undermined, and potentially nullified, by arguments: (1) that pension benefits are automatically vested without a review of actual legislative intent to form a contract, (2) that employees must be given a “comparable new advantage” for any disadvantage, and (3) that modifications are lawful only in the case of retirement system insolvency or a fiscal emergency. .

B. Absent “Unmistakable” Evidence That A Legislative Body Intended To Be Bound Indefinitely, There Is No Vested Right To Any Pension Or Other Retirement Benefit.

Retirement benefits involve potential long-term financial commitments for the life of an employee and the employees’ survivors, thus spanning 60 to 90 years. Accordingly, the California Supreme Court has held that the “legislative intent to create private rights of a contractual nature against the governmental body must be ‘clearly and unequivocally expressed.’” (*Retired Employees Assn. of Orange County, Inc. v. County of Orange* (2011) 52 Cal.4th 1171, 1186-1197 (“*REAOC*”) [quoting *Nat’l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co*. (1985) 470 U.S. 451, 466].) This is the “unmistakability” doctrine. (*United States v. Winstar* (1996) 518 U.S. 839, 860.) “[N]either the right of taxation, nor any other power of sovereignty, will be held . . . to have been

7 As explained by the New Jersey Supreme Court in *Spina v. Consolidated Police and Firemen’s Pension Fund Commission* (1964) 41 N.J. 391, “[i]t appears in some cases, notably in California, Georgia, and Washington, that the contract thesis was thought to be required lest the pension benefits fall within the constitutional ban against gifts of public moneys.” (*Id.* at 403 [citing *Kern v. City of Long Beach* (1947) 29 Cal.2d 848, 851 (“*Kern*”).) *Kern* had similarly acknowledged: “In some states pensions for government employees are treated as gratuities or bounties which can be withdrawn at any time. . . . In California, however, section 31 of article IV of the Constitution forbids gifts of public money to an individual, and this prohibition may have influenced our courts to hold that a pension right constitutes something more than a mere gratuity.” (29 Cal.2d at 851 [citations omitted].)

surrendered, unless such surrender has been expressed in terms too plain to be mistaken." (*Ibid*.)

Any vested rights claim "confronts a tropical-force headwind in the form of the 'unmistakability doctrine.'" (*Cranston Firefighters, IAFF Local 1363, AFL-CIO v. Raimondo* (1st Cir. 2018) 880 F.3d 44, 48.)

1. The "unmistakability" doctrine is necessary to preserve the state's sovereign authority

As recognized by the California Supreme Court in *REAOC*, whether a legislative enactment "was intended to create private contractual or vested rights or merely to declare a policy to be pursued until the legislative body shall ordain otherwise requires sensitivity to 'the elementary proposition that the principal function of a legislature is not to make contracts, but to make laws that establish the policy of the [governmental body].'" (*REAOC*, 52 Cal.4th at 1186 [quoting *National R.R*., 470 U.S. at 466].) "'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.'" (*Id.* at 1186 [quoting *Walsh v. Board of Administration* (1992) 4 Cal.App.4th 682, 697].) The requirement that "the government's obligation unmistakably appear thus served the dual purposes of limiting contractual incursions on a State's sovereign powers and of avoiding difficult constitutional questions about the extent of state authority to limit the subsequent exercise of legislative power." (*Winstar*, 518 U.S. at 875.)

The "unmistakability" doctrine has been applied rigorously by state and federal courts – including the courts of this state – to contract clause claims, involving both express and implied provisions.

2. The unmistakability doctrine applies to pension statutes, whether express or implied

The doctrine applies to express pension statutes. "The party asserting a contract clause claim has the burden of making out a clear case, free from all reasonable ambiguity, [that] a constitutional violation occurred." (*Deputy Sheriffs' Association of San Diego County v. County of San Diego* (2015) 233 Cal.App.4th 573, 578[finding no vested right to statutorily-created pension benefit].)

If there is any ambiguity, courts will not find a vested benefit. "Although both plaintiff retirees and the State advance plausible arguments on that question, the lack of such unmistakable legislative intent dooms plaintiffs' position." (*Berg v. Christie* (2016) 225 N.J. 245, 253 [COLA benefit].) Courts have held that the term "shall" is not dispositive.

(*Moro v. State of Oregon* (2015) 357 Or. 167, 225 ["The legislature's use of 'shall,' without more, is plainly insufficient to establish the irrevocability of an offer."].)

In contrast, courts have looked for explicit statements that the state is contractually bound or that changes are precluded. "The First Circuit has been quite hesitant to infer a contract where the state pension statute neither speaks in the language of contract nor explicitly precludes amendment of the plan." (*American Federation of Teachers v. State of New Hampshire* (2015) 167 N.H. 294, 302.) "[I]t is easy enough for a statute explicitly to authorize a contract or to say explicitly that the benefits are contractual promises, or that any changes will not apply to a specific class of beneficiaries." (*Id.* at 303 [concerning adjustments to the "earnable compensation" and COLAs].) "A legislature may demonstrate its intent to be contractually bound by using terms such as 'contract,' 'covenant' or 'vested rights.'" (*AFT Michigan v. Michigan* (Mich. Ct. App. 2014) 303 Mich.App. 651, 664, *aff'd sub nom*. *AFT Michigan v. State of Michigan* (2015) 497 Mich. 197 [citing S*tudier v. Michigan Public School Employees' Retirement Bd.* (2005) 472 Mich. 642, 663-64].)

Since the Supreme Court confirmed the unmistakability standard in *REAOC*, state and federal courts, citing *REAOC*, have applied its standard to preserve legislative authority. See *Vallejo Police Officers Assn. v. City of Vallejo* (2017) 15 Cal.App.5th 601, 620 ("In sum, the trial court did not err in ruling that VPOA did not meet its burden to show 'a clear basis' in the 2009 Agreement or 'convincing extrinsic evidence'. . . of a vested right to retiree medical benefits in the full amount of the Kaiser rate") [citation omitted]; *Fry v. City of Los Angeles* (2016) 245 Cal.App.4th 539, 552 (Charter amendments and later ordinances "do not evince a 'legislative intent' to create a vested right to a Board-determined subsidy amount. Rather, they evince an intent to reserve to the City Council the final decision authority over the subsidy"); *Retired Employees Assn. of Orange County, Inc. v. County of Orange* (9th Cir. 2014) 742 F.3d 1137, 1144 ("Missing here is 'statutory language or circumstances accompanying its passage clearly... evinc[ing] a legislative intent to create [implied] private rights of a contractual nature enforceable against [the County]' regarding the pooled health insurance premium.)

In summary, the "unmistakability doctrine" requires a strict threshold determination concerning whether the legislature in fact intended to be bound, without possibility of change, when granting a benefit.

C. Under the Theory of Deferred Compensation, Properly Applied, Benefits Promised In Connection With Completed Service Are Distinct From Benefits Attached To Future Service

Although the California Supreme Court recently affirmed the centrality of the "unmistakability doctrine," California case law remains muddled regarding the distinction between benefits that have been earned due to completed service, and prospective benefits based on service not yet rendered. The relatively few cases that have addressed the issue head-on do not suggest a principled basis for diverging from federal contracts clause jurisprudence, or from the law applied in most states outside of California.

1. The Concept of "Deferred Compensation" Applies Only To Completed Service

The doctrine of vested rights rests upon a theory of "deferred compensation" – that as employees work, they earn pension benefits to be paid at some future date. (*Marin Assn. of Public Employees v. Marin County Employees' Retirement Assn.* (2016) 2 Cal.App.5th 674, 695 ("*Marin*") ["[A] pension is treated as a form of deferred salary that the employee earns prior to it being paid following retirement."].) Under this theory, a number of judicial decisions, described below, recognize contract clause protection for benefits attached to time already worked, but not for periods not yet worked. "A rule that only protected accrued benefits would be consistent with the theory of pensions as deferred compensation; whereas a rule that protected future accruals . . . would be a significant, unprecedented change that goes beyond any known theory of deferred compensation." (Amy B. Monahan, *Statutes As Contracts? The "California Rule" and Its Impact on Public Pension Reform* (2012) 97 Iowa L. Rev. 1029, 1061.)

Both the *Cal Fire* and *Marin* decisions rested, in part, on the prospective nature of the changes at issue in those cases. (*Marin*, 2 Cal.App.5th at 708 ["The Legislature's change to the definition of compensation earnable was expressly made purely prospective by the Pension Reform Act. MCERA's responsive implementation was also explicitly made prospective only."]; *Cal Fire Local 2881 v. Cal. Public Employees Retirement Sys.* (2016) 7 Cal.App.5th 115, 131 ("*Cal Fire*") ["Nothing in the revised statutory scheme immediately destroyed plaintiffs' right to purchase the airtime service credit; rather the revised scheme set forth a deadline by which plaintiffs had to exercise this right in order to avoid losing it."].)

2. Case Law Recognizes The Distinction Between Past And Future Services

A number of other jurisdictions recognize the distinction between services performed and services yet to be performed, and find vesting only as to benefits attached to services already performed.

Florida's "preservation of rights" statute states: "rights of members of the retirement system established by this chapter are declared to be of a contractual nature, entered into between the member and the state, and such rights shall be legally enforceable as valid contract rights and shall not be abridged in any way." (See *Scott v. Williams* (Fla. 2013) 107 So.3d 379, 389.)

Yet the Florida Supreme Court held that that the legislature has authority "to amend a retirement plan prospectively, so long as any benefits tied to service performed prior to the amendment date are not lost or impaired." (*Id.* at 388-389.) The Florida Court explained:

> We stress that the rights provision was not intended to bind future legislatures from prospectively altering benefits which accrue for future state service. To hold otherwise would mean that no future legislature could in any way alter future benefits of active employees for future services, except in a manner favorable to the employee. This view would, in effect, impose on the state the permanent responsibility of maintaining a retirement plan which could never be amended or repealed irrespective of the fiscal condition of this state. Such a decision could lead to fiscal irresponsibility …… [We] conclude that the legislature has the authority to modify or alter prospectively the mandatory, noncontributory retirement plan for active state employees.

(*Id.* at 388.)

In *AFT Michigan v. Michigan* (Mich. Ct. App. 2014) 303 Mich.App. 651, the Court stated that, under the Michigan constitution, "'the Legislature cannot diminish or impair accrued financial benefits, *but we think it may properly attach new conditions for earning financial benefits which have not yet accrued*.'" (*Id.* at 681; see also *Advisory Opinion re Constitutionality of 1972 PA 258* (1973) 389 Mich. 659, 663 [finding constitutional a statute requiring members to pay an increased contribution to pensions with no corresponding increase in benefits].)

In *Everson v. State* (Haw. 2010) 122 Hawai'i 402, the Hawaii Supreme Court interpreted a state constitutional provision stating that membership in any employees' retirement system "shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired." (Id. at 408.) The court explained: "By adding the word 'accrued' before 'benefits,' . . . 'the delegates only sought to indicate that there 'can be no impairment of past benefits, but that [the] future benefits can be changed by the legislature[.].'" (*Id.* at 410.)

In *Professional Fire Fighters of New Hampshire v. State* (2014) 167 N.H. 188, the New Hampshire Supreme Court stated, in applying the "unmistakability doctrine: "We hold that there is no indication that in enacting . . . [the statute] the legislature unmistakably intended to bind itself from prospectively changing the rate of NHRS member contributions to the retirement system." (*Id.* at 196.) The Court relied on the decisions of the Florida and Michigan courts, cited above, recognizing that the legislature has authority "to amend a retirement plan prospectively, so long as any benefits tied to service performed prior to the amendment date are not lost or impaired."' (*Id*. at 195 [quoting *Scott*, 107 So.3d at 389].)

Similarly, in *Moro v. State of Oregon, supra,* 357 Or. 167, the Oregon Supreme Court stated: "Although we conclude that the legislature cannot change the COLA retrospectively, for PERS benefits already earned, it can change the COLA prospectively, for benefits earned by PERS members on or after the effective date of the amendments." (*Id*. at 231.)

In summary, a standard that distinguishes benefits tied to completed work is consistent with the theory of deferred compensation. And it is good policy: the Little Hoover Commission Report concluded that "[t]he only way to manage the growing size of California government's growing liabilities is to address the cost of future, unearned benefits to current employees, which at current levels is unsustainable." (Little Hoover Report at 42-43.)

3. The Failure To Distinguish Between Completed And Future Service Interferes With Collective Bargaining

The distinction between benefits already earned and benefits based on future service has become critical in collective bargaining. The courts began shaping the "California Rule" before the state legislature enacted the Meyers Milias Brown Act, which created significant additional protections for employees as to their pay and benefits through collective bargaining. (See Gov. Code § 3500(a) ["It is the purpose of this chapter to promote full communication between public employers and their employees by providing a reasonable method of resolving disputes regarding wages, hours, and other terms and conditions of employment between public employers and public employee organizations."].) But over the decades, the inflexible "California Rule" on modification of pension benefits has proven incompatible with the collective bargaining process.

An inflexible rule interferes with the ability to "trade off" future benefits for current wages. As things currently stand, employees may be frustrated in obtaining higher wages because of the cost to fund not only already earned, but also future unearned benefits. As observed by The Little Hoover Commission: "Workers might prefer to trade current job security and a livable wage for theoretical, yet-to-be-earned pension benefits . . . ." (Little Hoover Report at 19.) Moreover, "[i]n a time of fiscal contraction, failing to allow negotiation on prospective pension changes might very well lead to salary cuts, layoffs, hiring freezes, and reductions in other forms of fringe benefits." (Monahan, 97 Iowa L. Rev. at 1079.) On the employer end, there are employers that would like to create incentives for employees who have special skills or contribute to productivity, but cannot because doing so would increase pension liabilities.

The application of the vested rights doctrine in the collective bargaining setting is particularly problematic because some courts have generally viewed "vested rights" as individual rights that cannot be bargained. While this may make some sense with respect to benefits that have already been earned, it makes no sense at all for benefits for work not yet performed. This is particularly true because the line between pension matters and negotiated compensation is often blurry. For example, it does not make sense to say that employees cannot be asked to pay more for their pension benefits, as some courts have concluded, but the employer can reduce pay to accomplish virtually the identical result.

D. Even If A Right Is Vested, The Legislature Has The Power To Modify That Right Without Providing A "Comparable Advantage" In Circumstances Far Short Of Economic Emergency

1. There Need Not Be A "Comparable New Advantage" For Every Disadvantage

Three appellate courts of this state agree that there need not be a "comparable new advantage" for every disadvantage involved in a pension modification: *Alameda,* 19 Cal.App.5th, *Marin*, 2 Cal.App.5th 674, and *Cal Fire,* 7 Cal.App.5th 115.

In *Alameda*, the Court of Appeal agreed with the *Marin* Court that a modification "should" but not "must" include a comparable new advantage. According to the *Alameda* Court:

> After tracing the origin of the 'must' language to a 1969 appellate court decision and establishing that it has never again been reiterated by the Supreme Court, *Marin* makes, we feel, a convincing argument that the use of 'must' in *Allen II* was not 'intended to herald a fundamental doctrinal shift. Thus, according to *Marin*, the high court's vested rights jurisprudence generally requires only that detrimental pension modifications should (i.e., ought) to be accompanied by comparative new advantages – in effect, 'a recommendation, not . . . a mandate.

The *Marin* court conducted a scholarly review of the Supreme Court's prior rulings on the standard that governs modification of pension benefits for public employees, concluding that "since 1983, "the 'must" formulation has never been reiterated by the Supreme Court, which has instead uniformly employed the 'should' language from the 1955 *Allen* decision." (2 Cal.App.5th at 697-699.) And the Court noted that this Court's 1983 decision in *Allen* actually found "the reduction was not constitutionally improper," without evaluating any comparable advantage (*id.* at 699), making the term "must" dicta. The Court stated, "we cannot conclude that *Allen v. Board of Administration* in 1983 was meant to introduce an inflexible hardening of the traditional formula for public employee pension modification." (*Id.* at 699.)

a. The California Supreme Court Has Continuously Stated That Employees Have Only The Right To A Substantial and Reasonable Pension

The California Supreme Court has repeatedly stated that public pensions may be modified so long as a "substantial and reasonable pension" remains. Where the Court has found modifications to be unwarranted, the modification has either drastically reduced or destroyed the pension or no sufficient rationale was offered for the modification. For example:

- As originally stated in *Kern*: "the employee does not have any right to any fixed or definite benefits, but only to a *substantial or reasonable pension*. There is no inconsistency therefore in holding that he has a vested right to a pension but that the amount, terms and conditions of the benefits may be altered." (29 Cal.2d at 854-855 [emphasis added].) In *Kern*, the modification did not meet this standard because it essentially abolished the pension system on the eve of the plaintiff's retirement. (*Id.* at 855-856.)

- *Packer v. Board of Retirement* (1950) 35 Cal.2d 211 ("*Packer*"): "any one or more of the various benefits offered … may be wholly eliminated prior to the time they become payable, provided … the employee retains the right to a *substantial pension*." (Id. at 218 [emphasis added].) The Court held: "It is reasonably clear from the foregoing, however, that the employees, including Packer, retained rights to substantial pension benefits and, accordingly, that the 1941 revision did not exceed the scope of permissible modification." (*Id.* at 219.)

- *Allen v. City of Long Beach* (1955) 45 Cal.2d 128 ("*Allen*"): "[M]odifications *must be reasonable*, and it is for the courts to determine upon the facts of each case what constitutes a permissible change." (*Id.* at 131.) The Court disapproved the modification from a fluctuating to a fixed pension because the amendment not only "substantially decreases plaintiffs' pension rights without offering any commensurate advantages" but also "there is no evidence or claim that the changes enacted bear any material relation to the integrity or successful operation of the pension system established by section 187 of the charter.

- *Abbott v. City of Los Angeles* (1958) 50 Cal.2d 438. Relying on *Allen*, the Court stated that modifications must be "reasonable" and disapproved the modification from a fluctuating to a fixed pension for the same reasons in *Allen*. (*Id.* at 449.)

- *Miller v. State of California* (1977) 18 Cal.3d 808: "a public pension system is subject to the implied qualification that the governing body may make reasonable modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a *substantial and reasonable pension*." (*Id.* at 816 [emphasis added].) In *Miller*, this Court held that it was not a violation of the contracts clause to lower the age of retirement. (*Id.* at 817-818.)

- *Betts v. Board of Administration* (1978) 21 Cal.3d 859, 863 ("*Betts*"): "the employee does not obtain, prior to retirement, an absolute right to a fixed or specific benefits, but only to a '*substantial or reasonable' pension*." (emphasis added.) *Betts* stated only that "changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." (*Id.* at 864.) Although *Betts* disapproved of a change from a "fluctuating" to a "fixed" method of computing benefits, defendant in that case offered no justification for the change. (*Id.* at 867-968.)

- *Allen v. Board of Administration* (1983) 34 Cal.3d 114, 120 ("*Allen II*"). "With respect to active employees, we have held that any modification of vested pension rights must be reasonable, must bear a material relation to the theory and successful operation of a pension system, and, when resulting in disadvantage to employees, must be accompanied by comparable new advantages." Although *Allen II* used the term "must," the holding of the case actually turns on the threshold determination of whether the plaintiffs had a contractual right to the benefits they sought, which the court held they did not. (*Id*. at 124-125.)

- *Legislature v. Eu* (1991) 54 Cal.3d 492 ("*Eu*"): "[M]odifications must be reasonable and any `changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.'" (*Id.* at 529 [citations omitted].) In *Eu*, this Court did not use the term "must" but rather used the term "should" and based its decision on the fact that the future benefit had been destroyed. The changes did not

> "merely modify the LRS pension system; rather they terminate that system entirely as to additional benefits accruing for future services." (*Id*. at 530.)

In sum, this Court has repeatedly stated that public pensions may be modified so long as a "substantial and reasonable pension" remains.

b. The Comparative New Advantage Requirement Would Nullify The General Rule That Reasonable Modifications May Be Made So Long As There Remains A Substantial And Reasonable Pension

The "comparative new advantage" requirement eliminates the general rule – that pensions may be modified so long as a "substantial and reasonable" pension remains – with a proviso – that there "must" be a "comparable" advantage for every disadvantage.

This position essentially nullifies the state's sovereign powers and is thus contrary to contracts clause jurisprudence. A limitation on the government's reserved power cannot be "construed to destroy the reserved power in its essential aspects." (*City of El Paso v. Simmons* (1965) 379 U.S. 497, 509; see also *U.S. Trust Co. of N.Y. v. New Jersey* (1977) 431 U.S. 1, 23, n. 20 ["[A] state is without power to enter into binding contracts not to exercise its police power in the future."].) The California Supreme Court has long held that a statute may not be interpreted in this manner; a general rule may not be eliminated by a proviso to that rule. (*Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 735-736 [rejecting petitioner's interpretation because it "ascribes an unreasonably expansive meaning to the second sentence—the proviso" which "virtually read the first sentence out of the section"].) For the same reason, many argue that the Court should not permit the elimination of the touchstone of its jurisprudence regarding benefits for service not yet rendered – the "substantial and reasonable pension" standard -- to be obliterated by a proviso.

In fact, applying the equivalent benefit test to prospective benefits often makes no sense – and the *Cal Fire* case is a paradigm example. The change at issue there – eliminating "air-time" – is rooted in a recognition that granting the benefit in the first place was a perversion of good pension practice, and that the benefit led to unearned windfalls. It simply would not make sense to grant an "equivalent" benefit once it became clear that the premises relied upon in granting the benefit were flawed. It also makes no sense when the need to change a benefit arises out of economic concerns. Granting an equivalent benefit in either case would merely perpetuate the problem the public agency is seeking to address.

2. Modifications Must Be Upheld To Keep A Pension System Flexible, In Accord With Changing Conditions, And To Maintain The Integrity of The System

Based on long-standing instructions from the California Supreme Court, the law must permit pension modifications that protect against "advantages and burdens" that were "unforeseen" at the time a benefit was granted. For employees not yet retired, "prospective" modifications must be permitted so long as they leave a "substantial and reasonable" pension, are "reasonable" and "bear a material relation to the theory and successful operation of a pension system." A court need not find a fiscal emergency or permit only a temporary solution.

a. Modifications Must Be Permitted To Address Unforeseen Advantages And Burdens

The Supreme Court has stated: "An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system." (*Betts*, 21 Cal.3d at 863.)

This flexibility is needed to preserve sovereign power to consider future events and to protect already accrued benefits. As stated in *Allen II*, "The contract clause and the principle of continuing governmental power are construed in harmony; although not permitting a construction which permits contract repudiation or destruction, the impairment provision does not prevent laws which restrict a party to the gains `reasonably to be expected from the contract.'" (34 Cal.3d at 120 [citations omitted].) "Constitutional decisions `have never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change.'" (*Ibid.* [quotations and citations omitted].)

Based on this doctrine, *Lyon v. Fluornoy* (1969) 271 Cal.App.2d 774, found no constitutional impairment in a law that severed the tie between retired legislator's pensions and current legislators' salaries (which had increased three-fold), and instead gave retirees an annual cost of living increase. The court explained that: "To pay them allowances based upon the new . . . salary would hand them a bonanza far outstripping their expectations for cost-of-living increases, dwarfing their relatively modest contributions and demanding enlarged appropriations of general tax funds to maintain the retirement system's solvency." (*Id*. at 786.)

Similarly, recent calls for pension reform have resulted from these "unforeseen advantages and burdens." State and local governments have granted benefits based on financial projections, accepted at the time, but proven wrong by subsequent events. For example, as discussed above, in 1999, when SB 400 permitted increased pension formulas, “CalPERS claimed in its promotional literature the plan could be implemented ‘without it costing a dime of additional taxpayer money.’” (Little Hoover Report at 13.) As it turned out, these projections were wrong, because the 2008 recession, coupled with the higher than expected cost of the pension increases, plunged CalPERS deep into red ink. (*Id*. at 14.)

That red ink caused CalPERS to increase employer contributions to cover the resulting unfunded liabilities. Employees, in contrast, continued to contribute at reduced levels that did not support the actual cost of the benefit and thus reaped a windfall.[8] This is but one example of the effect of an “unforeseen burden” on employers, coupled with an “unforeseen advantage” for employees. Another is provided by the Cal Fire case itself. The purchase of air-time, although designed to be paid for by employees, actually resulted in large unexpected windfalls while saddling public employers with tens of millions of dollars of unforeseen liabilities.

b. Modifications That Are Limited To Prospective Service Are Subject to A Lesser Standard Than Already Earned Benefits

“Public employment gives rise to certain obligations which are protected by the contracts clause of the Constitution, including the right to the payment of salary which has been earned.” (*Miller*, 18 Cal.3d at 815.) But, as stated by the *Marin* court: “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].)

Accordingly, courts place great weight on whether a modification is prospective and require a lesser burden to support modification. Both the *Marin* and the *Cal Fire* cases rested, in part, on the prospective nature of the changes at issue in those cases. (*Marin*, 2 Cal.App.5th at 708; *Cal Fire*, 7 Cal.App.5th at 131.) Moreover, as discussed above, numerous other courts in other jurisdictions have approved modifications because they were prospective, applicable only to future work. (See, e.g., *Scott v. Williams*, 107 So.3d at 389 [the legislature has the authority to modify or alter prospectively the mandatory, noncontributory retirement plan for active state employees]; *AFT Michigan v. Michigan*, 303 Mich.App. at 669 [legislature may attached new condition for earning financial benefits which have not yet accrued]; *Advisory Opinion re Constitutionality of*

[8] As reported by the Los Angeles Times, “CHP officers who retired in 1999 or earlier after at least 30 years on the job collected pensions averaging $62,218” whereas for “those who retired after 1999, the average pension was $96,270.” (“The Pension Gap, Los Angeles Times, September 18, 2016.)

1972 PA 258. 389 Mich. at 663-664 [finding constitutional a statute requiring members to pay an increased contribution to pensions with no corresponding increase in benefits]; *Everson v. State,* 122 Hawai'i at 410 [under state constitution, there "can be no impairment of past benefits, but that [the] future benefits can be changed by the legislature"]; *Professional Fire Fighters of New Hampshire v. State*. 167 N.H. at 196 [the legislature has authority "to amend a retirement plan prospectively, so long as any benefits tied to service performed prior to the amendment date are not lost or impaired."]; *Moro v. State of Oregon*, 357 Or. at 231 [legislature could "change the COLA prospectively, for benefits earned by PERS members on or after the effective date of the amendments."].)[9]

c. Pensions May Not Be Destroyed, But Modifications Must Be Permitted If They Leave A Reasonable and Substantial Pension

As an initial matter, "alteration of contractual obligations" that is "minimal" does not constitute an unconstitutional impairment of contract, "end[ing] the inquiry at its first stage." (*Allen II*, 34 Cal.3d at 119.)

Moreover, in assessing the extent of the modification, courts look to whether the benefit was central to a party's agreement to enter into a contract. (See *City of El Paso,* 379 U.S. at 514 ["We do not believe that it can seriously be contended that the buyer was substantially induced to enter into these contracts on the basis of a defeasible right to reinstatement...."]; *Allied Structural Steel v. Spannaus* (1978) 438 U.S. 234, 243 n. 14 [noting that *El Paso* Court concluded that the "`measure taken ... was a mild one indeed'" because it did not affect term that induced contract].)

But even if a modification is not "minimal," the California Supreme Court has stated that "the governing body may make reasonable modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a substantial and reasonable pension." (*Miller*,

[9] *Legislature v. Eu*, 54 Cal.3d 492, 530-531, included statements concerning the vested nature of benefits tied to future work. But *Eu* in fact involved *the destruction of already earned benefits*, because "the statutory change threatened to divest the legislators of what they had already earned." (Monahan, 97 Iowa L. Rev. at 1068.) The modifications at issue in *Eu* sought to terminate the system entirely, "*which in turn threatened to entirely divest legislators of the benefits they had already accrued, though were not yet eligible to receive.*" (State Answer Brief at 42 [emphasis added].) Accordingly, *Eu* does not create a barrier to the conclusion that already earned benefits and prospective benefits are to be treated in a distinct manner.

18 Cal.3d at 816). "An employee may acquire a vested contractual right to a pension but… this right is not rigidly fixed by the specific terms of the legislation in effect during any particular period [the employee] serves," and "the amount, terms and conditions of the benefits may be altered*." (Kern*, 29 Cal.2d at 855.) "[A]ny one or more of the various benefits offered … may be wholly eliminated prior to the time they become payable, provided the employee retains the right to a substantial pension." (*Packer*, 35 Cal.2d at 218.) Under this standard, a court must review the extent of the modification to determine whether a "substantial and reasonable" benefit remains.[10]

Courts must make this determination on a case by case basis. "Such modifications must be reasonable and it is for the courts to determine on the facts of each case what constitutes a permissible change." (*Betts*, 21 Cal.3d at 863.) In *Marin*, the Court found that a "substantial and reasonable" pension remained, even after the elimination, from the pension calculation, of standby pay, administrative response pay, call back pay and other "premium" pays. (*Marin*, 2 Cal.App.5th at 704.) In *Cal Fire*, a "substantial and reasonable" pension remained after the withdrawal of the option to purchase "airtime." Withdrawing the airtime offer did not change what public employees could reasonably expect to receive in exchange for their labor. Indeed those who never purchased airtime saw no changes whatsoever to their expected pension once the offer was withdrawn.

In summary, for prospective benefits, yet to be earned, modifications must be permitted so long as a reasonable and substantial pension remains.

3. Changes Must Be Permitted When They Bear A Material Relation To The Theory Of A Pension System And Its Successful Operation

Some contend that only imminent fiscal collapse would justify modification to a pension benefit. This contention would nullify the Supreme Court's admonition regarding the need for flexibility in light of changing circumstances, and permit modification only when it is too late.

10 As explained in *Marin*, "[w]hen the Supreme Court says that pension rights may not be 'destroyed,' it means a pension system cannot be abolished on the eve of retirement," (2 Cal.App.5th at 701 [citing *Kern* at 29 Cal.2d 848].), "or not after substantial service has been provided," (*id.* [citing *Eu*, 54 Cal.3d at 492].), "or not by effectively abolishing a pension plan the legislative authority refuses to fund" (*id*. at 701-702 [citing, *inter alia*, *Bellus v. City of Eureka* (1968) 69 Cal.2d 336 and *Klench v. Board of Pension Bd. Commrs*. (1926) 79 Cal.App. 171]).

A contract modification will pass constitutional muster if it is "reasonable and necessary to serve an important public purpose." (*U.S. Trust Co. of N.Y.,* 431 U.S. at 25.) In making this determination, courts look to see whether there is a "significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem." (*Energy Reserves Grp., Inc. v. Kan. Power & Light Co* (1983) 459 U.S. 400, 411-412 [citations omitted].) "[T]he public purpose need not be addressed to an emergency or temporary situation." (*Id*. at 412; see also *Campanella v. Allstate Life Ins. Co*. (9th Cir. 2003) 322 F.3d 1086, 1088 [no need for emergency or temporary situation.]; Baltimore *Teachers Union, Local 340, AFL-CIO v. Mayor and City Council of Baltimore* (4th Cir. 1993) 6 F.3d 1012, 1020 fn. 11 ["The public purpose justifying an impairment of contract need not be "an emergency or temporary situation," although the existence of an emergency is of course relevant].)

Once a legitimate public purpose has been identified, the court determines "whether the adjustment of `the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption.'" (*Energy Reserves*, 459 U.S. at 412 [quoting *U.S. Trust Co. of N.Y.*, 431 U.S. at 22].)

The Supreme Court has repeatedly stated the standard for pension modification: whether the change bears "a material relation to the theory of a pension system and its successful operation …." (*Allen*, 45 Cal.2d at 131; *Allen II*, 34 Cal.3d at 120.) In *Marin*, the Court stated that: "Plaintiffs make no real effort to demonstrate why the Pension Reform Act's modification of the definition of compensation earnable does not 'bear some material relation to the theory of a pension system and its successful operation'." (2 Cal.App.5th at 707.)

In the *Cal Fire* case, the State's brief identified compelling policy justifications that satisfy the standard articulated by this Court. The State's policy justifications include (1) "restoring the link between pension benefits and public service" -- the purchase of airtime had artificially inflated the years used to calculate pensions, undermining trust in the system, (2) employees were using airtime to retire earlier than expected, depriving the state of veteran employees, and (3) employees were not in fact paying the entire cost of the airtime purchase, and it was falling on employers.

Given the minimal nature of the modification, the State's rationales are more than adequate.

E. It Is Not Necessary To Find Pension System Insolvency To Justify Changes In Benefits; Long Before A Pension System Is Insolvent, Cities And Their Retirees Will Be Harmed

In the recent *Alameda* case, the Court of Appeal suggested that only "total pension system collapse may be a sufficiently weighty concern" to justify changes in benefits for legacy members of the CERL system.

This statement displays a fundamental misunderstanding of how a pension system unravels. Long before a pension system goes broke – and that may never happen –cities and retirees will be irrevocably harmed. If a member employer, due to rising pension costs and lack of funds, ceases paying its annual contributions to CalPERS, CalPERS will cut retiree pensions. Similarly, if the member employee files for bankruptcy, the federal bankruptcy court has the authority to cut retiree pensions.

1. If A Member Employer Is Unable To Pay, CalPERS Cuts Retirees' Pensions

In *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 City of Stockton filed for Chapter 9 bankruptcy in part due to its inability to make its payments to CalPERS. The federal bankruptcy court found that retiree pensions could be reduced in bankruptcy. In so deciding, the court made two key observations: (1) when an employer can no longer afford to pay CalPERS, it is not CalPERS that bears the financial risk, (2) rather, the retirees bear the risk in the form of reduced pensions. *(Id.* at 40.)

As the *Stockton* court explained: "CalPERS does not bear financial risk from reductions by the City in its funding payments because state law requires CalPERS to pass along the reductions to pensioners in the form of reduced pensions. Rather, it is the pensioners, present and future, themselves who are at risk of loss." (526 B.R. at 41-42.) The Court further explained:

> The automatic reduction of benefits dictated by PERL § 20577 when a municipality does not pay its pension bill casts a different light on the CalPERS termination lien because it means that CalPERS bears no financial risk of underfunding of the termination pool. Rather, the individual members and their beneficiaries are the ones who bear the risk of inadequate funding. In effect, CalPERS is merely a servicing agent that does not guarantee payment.

(*Id*. at 49.)

The court concluded: "As has been explained, CalPERS must pass on to retirees the City's shortfalls in funding its City-sponsored pension, which makes CalPERS merely a pass-through conduit to the actual creditors." (*Id*. at 60.)

In the past few years, CalPERS has cut retiree pensions when member employers were unable to pay the cost of their employer contributions. (See "Public Workers From Two More Towns Expected To Lose CalPERS Pensions." Sacramento Bee, September 13, 2017.) As reported in the *Bee*: "In Trinity, five current and former employees will see their promised pensions slashed by 70 percent. Niland's five beneficiaries will see a 92 percent to 100 percent cut in pension benefits, according to CalPERS' staff reports." (*Ibid*.).

2. If An Employer Files For Bankruptcy, The Bankruptcy Court Has The Authority To Cut Retiree Pensions

In concluding that employee pension payments could be reduced as part of a bankruptcy plan, the *Stockton* court rejected CalPERS' argument "that California law insulates its contract from rejection and that the pensions themselves may not be adjusted." (526 B.R. at 39.) The court explained that the law of vested rights did not insulate pensions from reduction: "The rigidity of the California vested rights doctrine is a factor behind the current pressure on public pensions in California. It encourages dysfunctional strategies to circumvent limitations and peculiarities in California public finance." (*Id.* at 55.) The court held that:

> The fatal flaw in the "vested rights" analysis of California public pensions is that neither the Contracts Clause of the California Constitution nor the Contracts Clause of the Federal Constitution prevents Congress from enacting a law impairing the obligation of contract. The Supremacy Clause of the Federal Constitution resolves conflicts between a clear power of Congress and a contrary state law in favor of Congress.

(*Id*. at 56.)

Other bankruptcy courts also have held that pensions may be modified in bankruptcy. (See *In re City of Detroit, Mich*., (Bankr. E.D. Mich. 2013) 504 B.R. 97, 154 ["Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding. Moreover, when, as here, the state consents, that impairment does not violate the Tenth Amendment. Therefore, as applied in this case, chapter 9 is not unconstitutional."]; see also *In re City of Detroit* (Bankr. E.D. Mich. 2014) 524 B.R. 147, 180–181.)

In summary, imminent insolvency of the pension system, or even its members, cannot be the standard under which courts determine whether pension benefits may be modified. Long before any pension system or member is insolvent, its member agencies, unable to pay their annual contributions, will cut vital services, or default, and retirees will be penalized in the form of reduced benefits. The legislature must be permitted to identify and resolve problems before pension systems enter into this "death spiral."

V. CONCLUSION

Hopefully, the cases before the California Supreme Court will clarify the standards for judicial review of pension modifications. Among other things, the Court has an opportunity to confirm that (1) the "unmistakability doctrine" applies to all claims of vested rights, (2) benefits attached to time already worked are distinct, and subject to a different and lesser standard, than for time not yet worked, (3) there need not be a "comparable new advantage" for any disadvantage, (4) the touchstone of reasonable modification of prospective benefits is whether the change is based on unforeseen advantages and burdens, (5) an economic emergency is not required in order to modify prospective benefits.

The Court may tackle only the first of these issues in *Cal Fire*. Or, it may address the fundamental infirmity of the so-called California rule – perhaps repudiating the idea that it was ever a complete statement of the rule. The likelihood that it will address these issues has increased greatly because the Governor has strongly urged that reconsideration, and all three cases before the court address it. The court seems least likely to address the fiscal solvency issue. From a factual perspective, none of the cases before it are really based on solvency concerns. However, because the *Alameda* case directly addresses the issue in *dicta*, and does so in a manner that would be highly detrimental to cities, it is critical that the court at least leave the issue open for future consideration. Otherwise, even a favorable decision for cities may have a very dark underbelly – the prospect that cities will be unable to take actions necessary to address the affordability of future CalPERS rates.