COMMENTARY: Laws of Unintended Consequences: Pension Reform Gone Awry

"Don't throw out the baby with the bathwater!" Sage advice for those with small children. For the rest of us, this cartoonish idiom should remind us of the dangers of overcorrection.

Good public policy emerges when targeted solutions solve clearly identified problems. Bad public policy emerges when generalizations ("Public employee pensions are too generous!") and adversarial thinking ("No private employers provide benefits like that!") drive the debate.

Here, I wish to analyze two recent and related overcorrection trends in California public retirement law: One that has already occurred in the Legislature and one that may be unfolding now in the courts.

PEPRA

The Great Recession rocked retirement funds across the state and the nation. As plan sponsor contributions were skyrocketing, their revenues were plummeting. This perfect storm was causing state and local agencies to cut services, cut jobs and cut pay, bringing heightened attention to the proportion of their budgets that unfunded pension liabilities would consume for the foreseeable future. The Public Employees' Pension Reform Act ("PEPRA"), effective January 1, 2013, was passed to rein in pension costs that were viewed as unsustainable.

In the years leading up to PEPRA, there was no shortage of media coverage of "pension abuse." Extreme cases of pension "spiking" understandably enraged the public and politicians. Ire was directed at more than just the worst spiking offenders, because some systemic flaws also had arisen in California's pension laws during the flush years of the late 1990s and early 2000s.

Over-inclusive definitions of "compensation earnable" and a one-year "final compensation" period were invitations for pension spiking. Upgrading a retirement formula for service that had already been rendered resulted in windfalls for some lucky members. Allowing members to purchase "air time" service credit at the "full actuarial cost" was virtually guaranteed to result in systemic losses, due to self-selection (healthy members buy "air time" more often than unhealthy members) and lengthening lifespans.

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Contrast these systemic flaws with what was often described as "overly-generous" benefit formulae, such as 3% at 50 that became the standard for safety members in the early 2000s. So long as compensation earnable is not subject to manipulation, the projected value of a year of service credit under 3% at 50 can be determined with reasonable accuracy. Governments and their bargaining units can then account for that value when negotiating a comprehensive compensation package. Thus, 3% at 50 appears "overly-generous" only if one ignores the fact that employees would simply demand higher salaries if they earned pension benefits under a less generous formula.

PEPRA addressed many of the systemic flaws of California pension law by, among other things, requiring a 3-year final compensation period, narrowing the definition of "pensionable compensation," eliminating retroactive benefit formula enhancements and eliminating the right to purchase "air time." But, PEPRA went way beyond just resolving these systemic flaws. It also dramatically diminished the fundamental benefit formulae, increased member contributions and imposed caps on pensionable compensation. These changes did not address any systemic flaws; they just slashed benefits for new employees.

PEPRA's changes had little impact on public employees who were hired before January 1, 2013, so most applications of the practices that PEPRA was supposed to reform were left untouched. This has created two classes of public employees, with consequent recruiting and morale problems. It also has complicated collective bargaining, because the baseline benefits for otherwise similarly-situated public employees differ greatly based on an arbitrary hiring date.

Which begs the question: Could the PEPRA benefit formulae for new employees have been more equitable if the systemic flaws had not been perceived to be locked in for legacy (pre-PEPRA) employees under California's vested rights doctrine? That question leads me to the second overcorrection that may be unfolding in the courts.

Vested Rights

For decades, California's judiciary has

protected the vested contractual rights of public employees not only to receive the benefits they were promised for past service, but also to continue earning benefits under the same or better terms for future service. See *Legislature v. Eu* (1991) 54 Cal.3d 492. The protection of benefits already earned is intuitive for most observers, but the guarantee that benefits will never be diminished for future service is less so. Along with pension spiking, that guarantee to continue earning the same level of benefits for future service has driven the so-called "pension reform movement" in California.

Similar to how the Legislature took a blunderbuss rather than a surgical approach to pension reform in PEPRA, some courts have launched comprehensive, rather than targeted, attacks on the "vested rights" doctrine. In recent months, their rulings have started to gain momentum.

In *Marin Assn. of Public Employees v. Marin County Employees' Retirement Assn.* (2016) 2 Cal.App.5th 674 ("*MAPE*"), the First District Court of Appeal in San Francisco held that the Legislature could take away a vested pension right without providing any comparable offsetting advantage, so long as the affected employees were left with a "reasonable" pension. The Court reached this conclusion by finding that, in *Allen v. Board of Administration* (1983) 34 Cal.3d 114, the California Supreme Court did not intend to use the word "must" when it said: "With respect to active employees, we have held that any modification of vested pension rights … when resulting in disadvantage to employees, **must** be accompanied by comparable new advantages." The *MAPE* court noted that most Supreme Court and other appellate decisions both before and after *Allen* used the word "should" rather than "must." The court found it "unlikely that the Supreme Court's use of 'must' in the *Allen* decision was intended to herald a fundamental doctrinal shift" away from what the *MAPE* panel believed was always intended as merely a suggestion that disadvantages "should" be accompanied by comparable new advantages.

The MAPE ruling flies in the face of over a half century of jurisprudence. In many earlier cases, the challenged plan amendments left members with what could surely have been described as a "reasonable" pension, but the courts struck down the amendments anyway, because no corresponding advantages were provided to offset the newly-imposed disadvantages. As one of many examples, in *Legislature v. Eu*, then-current legislators retained the full value of all service credit they had earned. They were merely subject to the new rules for future service credit earned after being re-elected to a new term. Those new rules were the very same ("reasonable") rules that applied to the service of all newly elected legislators. But no corresponding advantage was provided to the then-current legislators, so that amendments could not be applied to them.

Months after the First District announced its *MAPE* ruling, a different panel of justices in the same District continued MAPE's assault on vested rights. At issue in *Cal Fire Local 2881 v. CalPERS* (2016) 7 Cal.App.5th 115, was the elimination of the right of CalPERS members to purchase "air time." The *Cal Fire* panel stated: "We agree with this conclusion [regarding "should" v. "must"] reached by our colleagues and, as such, reject plaintiffs' claim that, absent proof that CalPERS members were granted a comparable advantage, the Legislature's elimination of the airtime service credit must be deemed unconstitutional." The panel in *Cal Fire* also flipped decades of pension law on its head by finding that a constitutionally vested right exists only when there is a "demonstration of intent" by the Legislature to create a vested pension right. This contradicts repeated California Supreme Court precedent holding that such an intent is presumed unless the terms of the retirement plan indicate that they are subject to change. *See, e.g., Int'l Ass'n of Firefighters v. City of San Diego* (1983) 34 Cal.3d 292.

A Targeted Solution

The Supreme Court has granted review of the *MAPE* decision. The question now is whether the High Court will throw the baby (vested rights) out with the bathwater (perceived pension spiking). The Supreme Court could cement the most protective view of vested rights, by reaffirming *Legislature v. Eu*, without providing any further clarification. Or it could adopt the First District's logic in *MAPE* and *Cal Fire*, essentially eviscerating the vested rights doctrine in California. Then still, it might take a third path, by sensibly clarifying existing precedent.

The practices at issue in *Marin* and *Cal Fire* were arguably easy pickings for the Legislature if its goal was, indeed, to hasten the demise of the vested rights doctrine. In *Marin*, the law at issue was essentially an anti-spiking law; the service credit at issue *Cal Fire* was "cost neutral" only in theory. The First District's blessings of these specific plan amendments were not necessarily unreasonable, but its overreaching rationale cannot be reconciled with decades of judicial precedent.

But there is a principle within the existing precedent that could provide a more sensible alternative to the First District's approach. In *Allen v. Bd. of Admin.* (1983) 34 Cal.3d 114, the California Supreme Court explained: "Laws which restrict a party to those gains reasonably to be expected from the contract are not subject to attack under the Contract Clause, notwithstanding that they technically alter an obligation of a contract." Similarly, in *Walsh v. Board of Administration* (1992) 4 Cal.App.4th 682, the court of appeal explained: "Constitutional decisions have never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change."

Is it fair to say that the Legislature foresaw that members might manipulate the timing of when they receive certain pay items to enhance their benefits? Is the ability to engage in that kind of manipulation part of the immutable employment contract, or may the Legislature fine-tune the definition of "compensation earnable" to limit such manipulation when it comes to light? Do members have a vested right to purchase service credit that was intended to be cost neutral, but which actually leads to unfunded liabilities that the plan sponsors must pay?

Californians would be well-served if the Supreme Court focuses on the reasonable, common sense expectations of the parties and finds a way to separate the baby from the bathwater.

Jeffrey R. Rieger *is Counsel to Reed Smith, LLP, and a senior member of its Fiduciary Practice Group. The comments made in this article are exclusively the views of the author and not necessarily those of the firm or its clients.*