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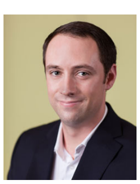
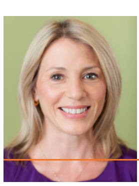
California Supreme Court Upholds Pension Reform Changes As Constitutional



by Raymond F. Lynch & Judith W. Boyette & Matthew J. Peck & Elizabeth J. Masson

Key Points

- The California Supreme Court clarified the so-called California Rule on public employee's "vested rights" to pension benefits, holding that detrimental financial changes to employee pension benefits do not invariably require that offsetting comparable new advantages be provided. And it set a legal framework for analyzing that issue.
- The pension reform changes did not violate employees' Constitutional rights because they closed loopholes that had allowed abusive pension practices (i.e. pension spiking); comparable new advantages were not required because that would have allowed the abuse to continue.
- The Court left open possibilities for future pension changes necessary to address substantiated threats to the viability of a pension system.

On July 30, 2020, the California Supreme Court issued a much-anticipated decision on the so-called "California Rule", which governs the permissible scope of pension modifications for public employees: *Alameda County Deputy Sheriffs' Association et al. v. Alameda County Employees' Retirement Association et al.* ("*ACERA*"). The California Rule has historically been interpreted to require that any detrimental change to a pension benefit must reasonably relate to the theory of a pension system and its successful operation, and either must or should (based on differing language in court decisions) be accompanied by a comparable new advantage, or the change would impair the public employees' "vested" pension rights in violation of the Contract Clause of the State and Federal Constitutions. The High Court confirmed that "should," not "must" is the correct formulation.

The *ACERA* case involved the application of the California Rule to changes made to certain County retirement systems by the Public Employee Pension Reform Act of 2013 ("PEPRA"). PEPRA changed the definition of "compensation" for employees covered by the County retirement systems in ways that would result in lower pension benefits. Employees sued to have prior compensation rules apply, arguing that the changes violated their claimed vested rights to pension benefits, and also violated existing pension settlement agreements that had provided promised benefits.

The "California Rule" About Changes to Pension Benefits Does Not Always Require "New Comparable Advantages"

The California Rule has been construed to mean that once an employee has begun public employment, the rate at which that employee earns or accrues pension benefits cannot be reduced—even for future service the employee has not yet performed—unless the reduction is accompanied by a "comparable new advantage." Many court-watchers hoped that the Court would use *ACERA* as a vehicle to reconsider the viability of the California Rule. In fact, the Governor's Office and several interest groups urged the Court to clarify that the California Rule does not apply to prospective reductions to pension benefits for service which has not yet been performed and, instead, only applies to pension benefits that have already been earned through prior service. The Court rejected that argument.

While the Court's decision did not go as far as some may have wanted, the Court narrowed and significantly clarified the practical application of the California Rule by rejecting a rigid formulation of it that would always require comparable new advantages to be provided.

Court Describes Two-Part Test for Valid Changes to Pension Benefits

The *ACERA* decision sets a two-part test for determining whether a change to pension benefits impairs employees' vested rights under the California Rule. First, a court must determine if the change is "detrimental" to employees, and if so, whether the change will include any comparable new advantages for employees. Typically, the answers are "yes" - the change is detrimental, and "no" – there are no comparable new advantages.

Next, the court must decide if the impairment of employees' pension rights is justified by a sufficient purpose, such as keeping the pension system sustainable. Reliance on that purpose requires that the change bear some material relation to the theory of a pension system and its successful operation. When the purpose is sufficient, no new comparable advantages are required if they would "undermine or otherwise be inconsistent with" the purpose of the change.

In *ACERA*, the Court held that the PEPRA changes that were intended to eliminate or reduce "pension spiking" were made for a sufficient purpose and bore a material relation to the theory of a pension system and its successful operation. The Court then held that, because that purpose would be undermined if new comparable advantages were provided, the changes did not violate employees' vested rights.

Settlement Agreements between Public Employers and Employees Cannot Override Pension Plan Terms as Lawfully Amended

The Court also held that settlement agreements previously entered into that allowed certain compensation to be included in calculating employees' pay for pension purposes could not prevent the Legislature from making future changes that had a retroactive effect on pension calculations. This means that employees could not force pension plan administrators to apply terms in a settlement agreement that were inconsistent with the terms of the pension plan as amended by the pension reform legislation. Further, the settlement agreements did not – and could not - promise employees that benefits would be paid in conflict with any future lawful changes to the plan's terms.

What The *ACERA* Decision Means For Public Employers And Retirement Systems

First, for the County retirement systems and their participating employers directly affected by the decision there are practical steps that need to be taken as a result of the *ACERA* decision. Some employees (and retirees) may have over-contributed. This determination would need to be made based on the manner in which employee contributions were, in fact, determined by each system. Correcting over- or under-contributions may require coordination with the employers participating in the system, including adjustments to future payroll deductions or refunds. Similarly, retirees may have been over-paid benefits, depending on the way in which the particular system has operated since the passage of PEPRA. Corrections should be made in accordance with the tax rules, depending on the particular facts and circumstances involved.

With respect to future changes for the county systems or other public retirement plans, proposed changes will continue to be subject to the California Rule analysis now established in *ACERA*. To the extent "loopholes" in public pension plans still exist that are abusive of the pension system, particularly by a minority of participants to the detriment of the system as a whole, authority now exists to lawfully eliminate those provisions in a way that does not violate the California Rule. Perhaps most importantly, this decision offers California public employers that may be facing even greater financial constraints due to the COVID-19 pandemic than those that prompted the passage of PEPRA an ability to develop options to deal with these issues. The Court left open the possibility that financial difficulties could rise to the level of allowing vested right benefit reductions without providing new comparable advantages. This would require current evidence of threat to the viability of the pension system, consistent with the *ACERA* analysis.

Some public retirement plans may be so under-funded that COVID-related revenue reductions would give rise to a current substantiated impossibility to maintain the retirement system. The Court cautioned that it had previously questioned whether it would be possible to eliminate a pension system, even if the cost were to become of "staggering proportions," because the pension system was "essential" to attract qualified employees. In that case, however, the claim that employer-required contributions would reach "staggering proportions" was only hypothetical. Today there well may be sufficient evidence that employers can still attract qualified workers without a rich pension plan, and it is not hard to imagine how employer contributions required to sustain current pension systems could actually reach "staggering proportions" in the near future.

The *ACERA* decision did not clarify precisely what form the new comparable advantages that "should" be provided to affected employees to offset the financial impact of pension changes. It is yet to be determined precisely what might satisfy the requirements. But it is welcome news that the Court reaffirmed the need and clarified the constitutional framework to deal with pension changes in response to actual threats to the viability of a pension system.

For more information, please contact:

Raymond F. Lynch, Partner
415-995-5055
rlynch@hansonbridgett.com

Judith W. Boyette, Partner
415-995-5115
jboyette@hansonbridgett.com

Matthew J. Peck, Senior Counsel
415-995-5080
mpeck@hansonbridgett.com

Elizabeth J. Masson, Partner
415-995-5106
LMasson@hansonbridgett.com