



Pensions, the
Coronavirus, and The
CA Supreme Court
Municipal Finance Institute

December 11, 2020

Topics

- The Evolution of the “Pension Buck”
- Pre-COVID-19 Pension Sustainability
- What Can You Expect in 2021?
- History – the “California Rule”
- Limits on the Rule
- Two key questions – is it vested, can it be changed?
- Recent California Supreme Court decisions
- The Good News
- The Missing Link
- What’s Next?

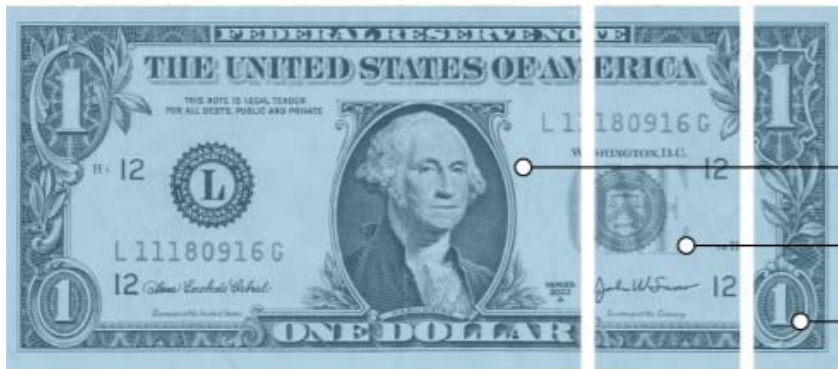


The Evolution of the “Pension Buck”

December 11, 2020

The Evolution of the “Pension Buck”

2015



Every dollar paid to CalPERS retirees comes from three sources:

- 67¢ Investment Earnings
- 21¢ CalPERS Employers
- 12¢ CalPERS Members

Source: CalPERS, Income over the last 20 years as of June 2014. Figures are updated following the close of each fiscal year.

The Evolution of the “Pension Buck”

2020



13¢

CalPERS
members*

29¢

CalPERS
employers*

58¢

Investment
earnings*

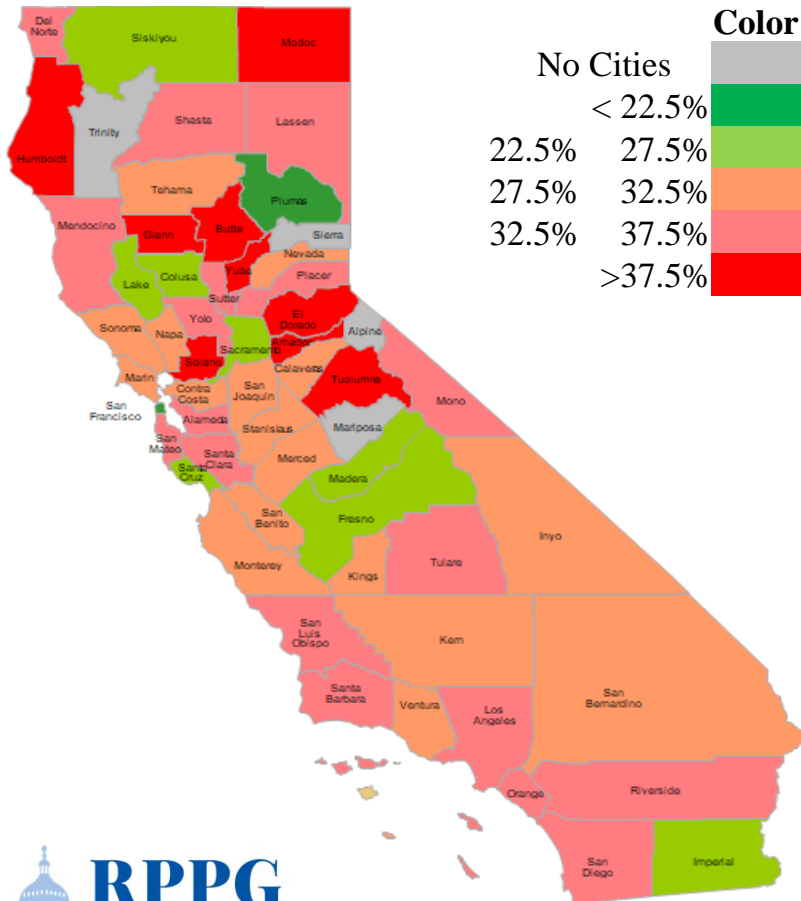
* As of
June 30,
2019



“Pre-COVID-19” Pension Sustainability

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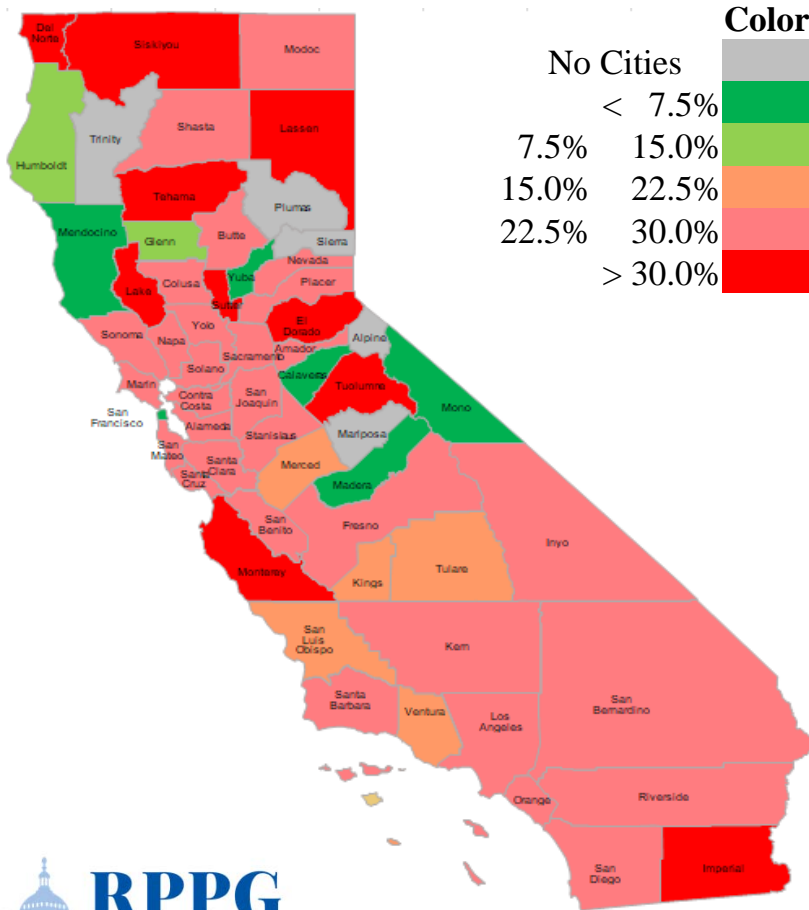
"Pre-COVID-19" Pension Sustainability Overview (Misc)



- Average of projected 2025/26 CalPERS **Miscellaneous Employer** contribution as a percent of covered payroll for all Cities in each County
- Average employer contribution rate = **33.4% of covered payroll. Note: Assumes 7.00% return Does not include OPEB**

Data from CalPERS 2018 actuarial valuations; 449 Cities and Towns

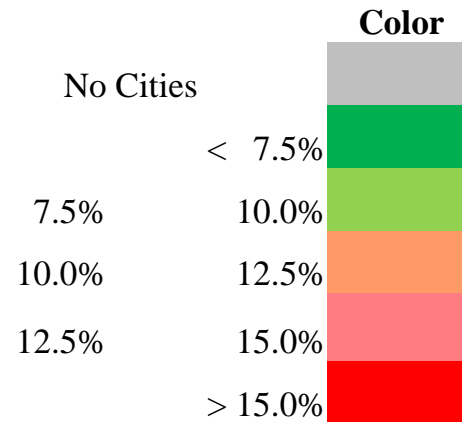
"Pre-COVID-19" Pension Sustainability Overview (Safety)



- Average Employer contributions projected to increase by 30+ percent or more from FY 20-21 to FY 25-26
- Average employer contribution rate = 61.5% of covered payroll. Note: Assumes 7.00% return. Does not include OPEB

Pension Payments as a percentage of General Fund Budget

- By FY 25/26 Cities on average will pay around 18.4% of their entire general fund towards pension contributions





CalPERS Employer Rates

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CalPERS Employer Rates: Factors for Future Increases

- Local governments are the insurer of defined benefit plans. If CalPERS misses the mark, employers assume the liability.
- The lower the funded status the less risk tolerance CalPERS can absorb.
- CalPERS earned 4.7 percent for FY 19/20 falling short of the 7 percent baseline.
- Losses are now amortized over a 20-year period versus 30.
- Minimum contributions (not including OPEB) continue to grow year over year.

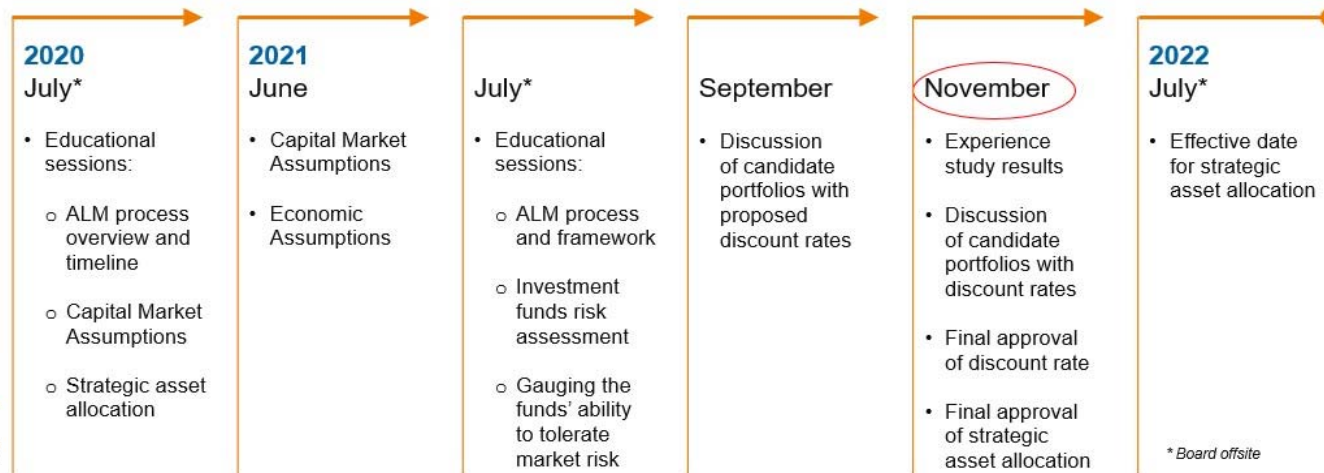


What Can You Expect in 2021?

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Policies/ Politics in 2021

- Relatively “light” year in pension legislation due to COVID-19
- If enacted, AB 2967 (O’Donnell) will limit local flexibility.
- Anticipate more measures in 2021 to divest, shift liability to employers, limit local options.
- CalPERS Board of Administration by and large continues to be very “pro member” versus “pro employer”.
- CalPERS will be conducting their ALM Cycle to determine if a discount rate reduction and other adjustments to cost-driving assumptions are needed.
- Don’t be surprised if there is a push for a 2022 ballot initiative.





History of the California Rule

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The “California Rule”

- Pension benefits become vested when an employee begins service for an employer (*Kern* – 1947)
- When positive changes are made to a pension system during employment, such changes become vested as well (*Betts* -- 1978)
- Once vested, pension benefits can be changed, however, changes must
 - Be reasonable (*Allen I* – 1955)
 - Relate to the theory of a pension system and its successful operation (Id.)
 - Should or must be accompanied by comparable new advantages (*Allen II* – 1983)
- Employees have the right to earn future benefits through continued service, on terms substantially equivalent to those existing when work commenced (*Eu* – 1991)



Limits on the “CALIFORNIA RULE”

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REAOC v. County of Orange

- The “legislative intent to create private rights of a contractual nature against the governmental body must be ‘**clearly and unequivocally expressed.**’ ”
- “Thus, it is presumed that a statutory scheme is not intended to create private contractual or vested rights and a person who asserts the creation of a contract with the state has the burden of overcoming that presumption.”

The Post-*REAOC* World

- After the decision in *REAOC*, the question on everyone's mind was whether a similar analysis would apply to pensions, despite a number of cases dating from 1947 to the present that suggest pension benefits are automatically vested upon the commencement of employment.
- The focus, particularly in the area of vested pension benefits, is prospective service – i.e. can the benefits of existing employees who have yet to retire be changed for service not yet rendered?
- For the most part, pension benefits of retirees are assumed to be vested.

Prospective Benefits Matter – A LOT

- The importance of the prospective benefit issue cannot be overstated. The present value of projected benefits for active members can be as high as 40% of the total CalPERS liability for most jurisdictions.
- There is a significant risk that, if a recession occurs, the funded ratio will drop as it did in 2009. The only “lever” that could reasonably be expected to reduce pension liability is changes to prospective benefits of active employees.
- However, even if the law were settled, changes to CalPERS or the '37 Act would require legislative approval.

PEPRA

- PEPRA did little to lower the cost of existing employees. But, it did do a few things:
 - It eliminated certain abuses such as “air time”
 - It eliminated the inclusion of terminal pay, payments for unused sick and vacation ('37 Act only)
 - It allowed employers to impose up to a 12% employee contribution for safety employees and 8% for miscellaneous employees

Challenges to PEPRA Reforms

- The relatively few provisions of PEPRA affecting existing employees have been challenged judicially.
- The California Supreme Court granted review in a number of cases, but designated and heard two cases, *Cal Fire Local 2881 v. California Public Employees' Retirement System* (**Cal Fire**) and *Alameda Deputy Sheriffs' Assn., et al. v. Alameda County Employees' Retirement Assn, et al.* (2018) 19 Cal.App.5th (**Alameda**), as lead cases.
- *Marin Assn. of Public Employees v. Marin County Employees Retirement Sys.* (2016) 2 Cal. App. 5th 674 (**Marin**), the most sweeping Court of Appeal decision was dismissed by the Supreme Court, after its decision in *Alameda*.

The Two Major Questions in All of the Cases

1. Are the benefits at issue vested?
2. If they are vested, under what circumstances can they be changed?
 - What rationale justifies change?
 - Is it necessary to grant an equivalent benefit?





CAL FIRE Local 2881 v. CalPERS

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Cal Fire – Analysis

- The Court reaffirms that terms of public employment are generally set by statute and are therefore subject to modification by the legislative body.
- While collective bargaining agreements can modify this principle, this generally applies only while the MOU is in effect.
- **The Court recognizes two exceptions: (1) where the legislature clearly intends to create contractual rights, and; (2) pension rights that constitute deferred compensation.**

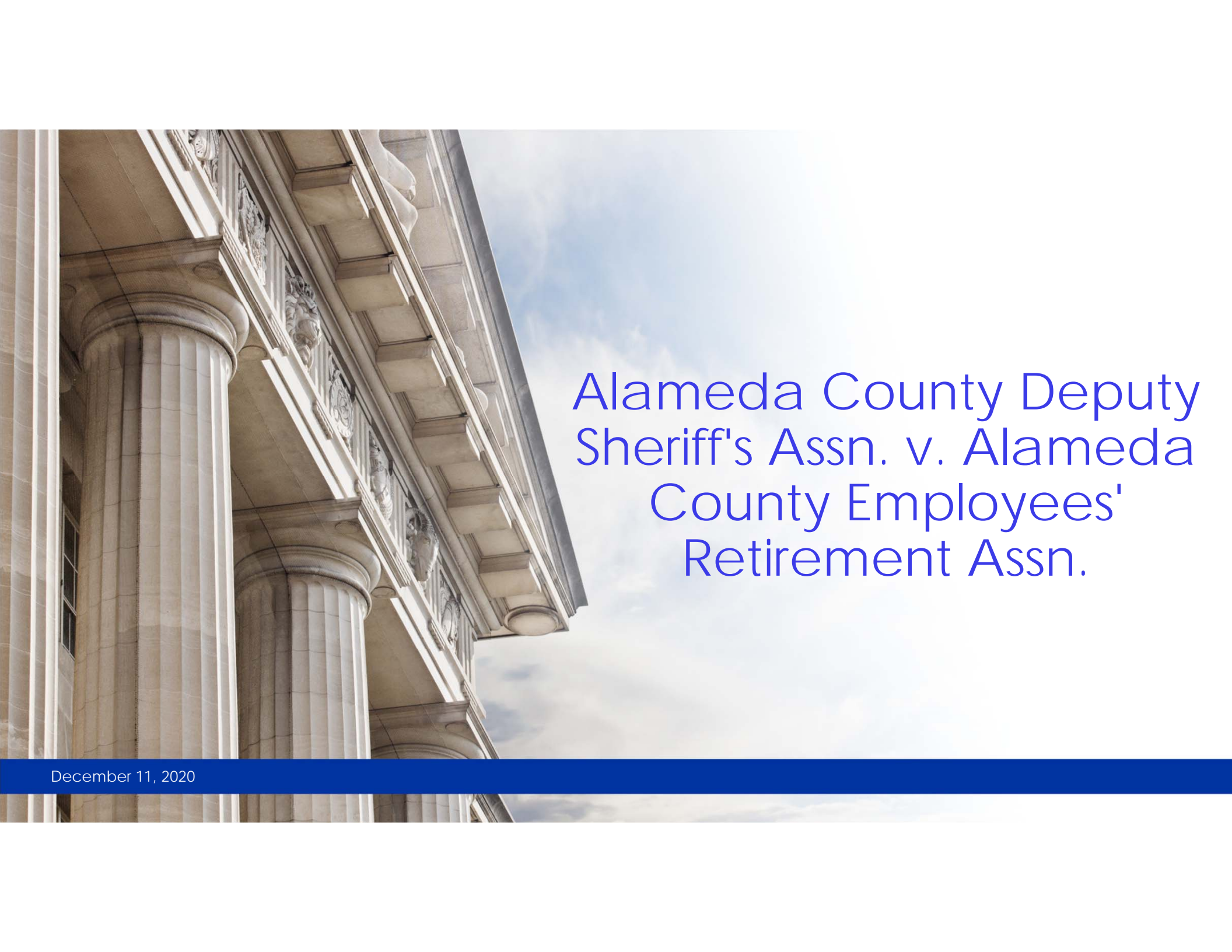
The *Cal Fire* Decision – Holding

HOLDING:

- The Court found no intention by the legislature to create a permanent right to air time.
- Nor could air time be considered deferred compensation because it was not “earned” through service.
- At most, “air time” was only an offer – employees had the option to accept it by serving 5 years and paying for it.
- The mere fact that air time affected pension did not make it a pension benefit for the purpose of vesting law.

Good News

- The Court utilizes REAOC's language requiring that any promise by the legislature be clear, despite arguments by the plaintiffs that REAOC does not apply to pension cases and only applies to implied contracts.
- The Court distanced itself from Court of Appeal decisions applying vesting analysis outside the pension sphere:
 - "We have never held...that the constitutional protection afforded pension benefits, which attached even in the absence of manifest legislative intent to create contract rights, extends generally to other benefits of public employment."
 - "We have never held that statutory terms and conditions of employment gain constitutional protection merely from the fact of their existence, even if they have persisted for decades."



Alameda County Deputy
Sheriff's Assn. v. Alameda
County Employees'
Retirement Assn.

December 11, 2020

Pension Spiking

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

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

The Decision

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

HOLDING:

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

HOLDING:

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

The Court: Justification for Change

- For the first time, guidance on what justifies change to a vested benefit.
- The Court finds that the PEPRA provisions “bear[s] some material relation to the theory of a pension system and its successful operation.”
- Because “[a] legislative intent to align the express language of a pension statute more closely with its intended manner of functioning directly relates to both the theory of a pension system and its successful operation.”
- The Court explains that “the inclusion in final compensation of the items of compensation excluded or limited by the PEPRA amendment can be viewed as distorting the pension calculation and increasing pension benefits beyond the amount anticipated by the underlying theory of compensation earnable.”

The Court: Comparable New Advantage

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

No Comparable Benefit is Required

- The Court acknowledges that PEPRRA does not provide a comparable benefit to the vested rights it removed by prohibiting the spiking practices.
- But the Court upholds the provisions because providing such advantages would **frustrate the amendment's "constitutionally permissible purpose."**
- Because the purpose of the PEPRRA provisions was to ban "spiking" — a practice inconsistent with the intent of CERL — adding a comparable advantage was not required.

The Good News

- The Court added some much-desired substance concerning what are permissible purposes for modifying vested rights, which could be helpful in future cases where modifications are necessary.
- The Court also arguably created a back door in the California Rule by permitting the modifications without including comparable benefits, when doing so would frustrate the permissible modifications.
- The Court noted that a truly “prospective” modification would be one “that applies only to pension rights accrued after its effective date while preserving unchanged the law applicable to pension rights accrued prior to that date.” Although that statement is dicta, tailoring a modification so it applies in this manner is a potential avenue around the California Rule.

The Future of Pension Reform Remains Uncertain

- We may need to wait for a test case involving changes to core pension elements prospectively — however, given the makeup of the state legislature, that is unlikely.
- That means any change to benefits will most likely come from an initiative or changes to an independent pension plan.
- What we do know is that such an initiative will probably raise an open issue that has yet to be decided by the Supreme Court.

Thank you! Questions?



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