July 2020 California Supreme Court Ruling Ends Spiking, Leaves California Rule Intact

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The REA, both independently and as a founding member of the San Diego Retirement Security Roundtable, monitors actions that impact defined benefit retirement plans in California and elsewhere. Our mission includes supporting defined plans, tracking threats to defined benefit plans, and to promoting retirement security for all (both public and private).

On July 30, 2020, the California Supreme Court (CSC) issued a key ruling on public pensions. Many REA members may have read about this ruling, which addresses the "California rule." While the pensions of retirees were not in question in this case, it's important to understand the issues at hand and how this may affect public pensions in future.

In 1955, the CSC issued a ruling which is now referred to as Allen I. This case established court precedent with respect to public pensions that has withstood many subsequent rulings. It has come to be known as the California rule.

The fundamentals of the California rule are that in a case where a public employee is hired and offered a pension, a contract is established between the employee and the employer. That contract is protected by the contract clause of the California constitution and the employer may not abridge that contract by lessening the promised pension benefits during the employee's tenure (and prior to retirement).

This ruling, and subsequent rulings, became a cause célèbre of pension critics over the past 20 years or so. Many of those critics, upset over enhancements to pension, perceived underfunding of pensions, and the existence of public pensions at all, argued that the California rule was not sacrosanct.

Their basic argument was that when public employers are under stress, they should be able to reduce pension benefits for existing employees. (It is fully agreed that a public employer can reduce pension benefits for new employees, prior to hire.)

One of the targets of those with concerns about pensions was actions by employees perceived to represent abuse of the pension systems. A key concern was pension "spiking," under which employees use various tactics to increase their pay during the final years of their service, upon which final benefits are typically calculated.

One effort to address this was the California Public Employees' Pension Reform Act of 2013 (PEPRA), which was passed by the Legislature, signed by Governor Brown, and became effective January 1, 2013. It applied to certain county retirement systems. Aspects of this act applied not only to new (not yet hired) employees, but also existing employees, known as legacy employees, thus setting up a challenge to the California rule.

This law removed from “compensation earnable” (for purposes of calculating a pension) payments for unused vacation, annual leave, personal leave, sick leave, or compensatory time off, however denominated, whether paid in a lump sum or otherwise, in an amount that exceeds that which may be earned and payable in each 12-month period during the final average salary period, regardless of when reported or paid. It also excluded pay received for pay additional services rendered outside of normal working hours (e.g. standby pay). These are just examples. The law included other things that have been characterized as examples of pension spiking.

Two court cases came forward to challenge this issue. One of these, Alameda County Deputy Sheriff’s Association et al., v. Alameda County Employees’ Retirement Association et al., is known generally as Alameda, although it is actually three similar cases from three counties combined. This is the one in which the CSC recently ruled and that ruling will presumably apply equally to the other case.

Before reaching the CSC, each of these cases were heard by an appellate court. The appellate ruling in the second case was of particular concern to pension advocates. That case is Marin Association of Public Employees et al. v. Marin County Employees’ Retirement Association et al.

The Marin appellate court noted that, “Plaintiffs’ essential position is clearly set out in their opening brief: “[P]ublic employees earn a vested right to their pension benefits immediately upon acceptance of employment and . . . such benefits cannot be reduced without a comparable advantage being provided.””

The Marin appellate court stated, instead, that, “As will be shown, while a public employee does have a “vested right” to a pension, that right is only to a “reasonable” pension—not an immutable entitlement to the most optimal formula of calculating the pension. And the Legislature may, prior to the employee’s retirement, alter the formula, thereby reducing the anticipated pension. So long as the Legislature’s modifications do not deprive the employee of a “reasonable” pension, there is no constitutional violation.”

The concern about this ruling for pension advocates revolves, in particular, around the term “reasonable.” This is obviously a subjective term and could potentially mean that a court might substantially reduce a pension promised to an employee by declaring the reduced pension to be reasonable.

The CSC decided to first rule on the Alameda case, which was decided in favor of the employees, versus the retirement system. While more than one issue was before the CSC, the key aspects for our purposes were the constraints on spiking and inclusion of other pay enhancements for legacy employees imposed by PEPRA.

On that question, the Supreme Court said, “PEPRA’s amendment of section 31461 did not violate the rights of county employees under the constitutional contract clause.” Note, importantly that the Supreme Court did not state that the constitutional contract clause with respect to pensions (the California rule) is invalid, but only that this case was not a violation of the California rule.

The Supreme Court declared that the contract clause is actually critical: "If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all."

The Supreme Court cited the 1955 case (Allen I), "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. Such modifications must be reasonable . . . . To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." The Supreme Court said, "This quotation from Allen I is the foundation of the California Rule."

The Supreme Court found, in the case before it (Alameda), that the law was enacted, "… for the constitutionally permissible purpose of conforming pension benefits more closely to the theory underlying section 31461 by closing loopholes and proscribing potentially abusive practices." They found this notwithstanding acknowledging that these changes reduced benefits for some employees who would otherwise have engaged in pension spiking to their personal benefit.

The Supreme Court referenced an earlier case, "[t]he 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." The Supreme Court went on to say, "While acknowledging this need for flexibility, we held in Allen I that modifications of public pension plans are permissible only if they relate to the operation of the plan and are intended to improve its functioning or adjust to changing conditions, holding that "alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation . . . .""

The Supreme Court apparently concludes that pension spiking is an "abusive practice" which was never intended as a benefit and places the retirement system at risk. In that regard, they seem to say that the system's benefit structure was never designed to allow people to artificially inflate their pensions beyond their basic salary and when people began doing so, it undermined the stability of the pension system itself. Therefore, this could be stopped without infringing on the contract clause because it was never really part of the "contract."

Indeed, they say, "… 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 CSC warned though, that it is not open season on pensions: "Plainly, however, the recognition that pension benefits are not immune from change does not grant carte blanche to the Legislature. As discussed at length above, the California Rule has two components: The

Legislature must act for a proper purpose and the net level of benefits “should” be preserved. The logical implication of the latter component is that the contract clause requires 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.”

So it seems that the California rule survives, but is not all-encompassing. That said, the emphasis on reasonableness and “should” when discussing replacement of one benefit for another may create a roadmap for future pension “reformers.” It would appear that some pension benefits may be cancelled without running afoul of the California rule.

The bottom line conclusion here seems to be along these lines: If one is hired and offered, for example, a 2% credit per year of service and one works 30 years, one would be deserving of 60% of base pay (compensation earnable) during the final year(s) used to calculate the final benefit. Changing that offset to 1% during the employee’s career would presumably violate the California rule and the Supreme Court would rule against such a measure. However, were employees to find ways to adjust that above 60% through some as yet unimagined method that is inconsistent with the intent of the retirement system, that could be eliminated.

The Marin case will presumably be resolved similarly and all current challenges of significance to public pensions in California will be resolved. Who knows about the future?

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