Gurtin Municipal Bond Management

Municipal Credit Update

The California Rule: Will 60 Years of Pension Precedent Hinge on Word Choice?

December 2016

The perception of ironclad pension protections in California would be considerably weakened should the California Supreme Court uphold a recent game-changing appellate court ruling, and this could send powerful reverberations across the state of California as well as into the broader municipal landscape if other states choose to follow California's path.

On November 22, the California Supreme Court chose to venture into the contentious world of public pensions when deciding to review a recent appellate court ruling, *Marin v. Marin County Employees' Retirement Association (MCERA) et al.*[1] Hearings will likely be delayed until later in 2017 after another appellate case on the same issue concludes,[2] but the case has the potential to mark a radical shift in pension policy within the state.

If the California Supreme Court upholds the lower court ruling, it would overturn decades of legal precedent that have applied to public pensions in California, likely resulting in significantly weakened pension protections. Consequently, we would expect a potential rush of California municipalities looking to improve their overall fiscal health by using the new flexibility to trim pension benefits for current employees.

1 Marin Assn. of Public Employees v. Marin County Employees' Retirement Assn. (2016) 2 Cal. App. 5th 674.

2 The California Supreme Court has deferred action on the Marin case pending the decision in Alameda County Deputy Sheriff's Association et al v. Alameda County Employees' Retirement Association et al, Court of Appeal, First Appellate District, Division Four, Case A14193, which deals with the same issue.

Previous California case law on pensions has evolved and coalesced over the years to the point where legal protections for public pensions in California have been considered among the most stringent in the country. [3] The courts have generally ruled that employees are due the same pension benefits as promised on their first day of employment and that any benefit reductions after that date need to be offset by "comparative new advantages," what has become known as the California Rule. In *Marin*, the appellate court rejected this historic interpretation of the California Rule and asserted that the long-standing requirement to have a "comparative new advantage" was less of a requirement and more of a suggestion, arguing that the only guaranteed pension is one that is "reasonable."[4]

Must or Should? The Future of Pensions in California May Rest on the State Supreme Court's Word Choice.

The central tenet of the appellate court's argument hinges on the use of the word *mus*t versus *should*, as the two words were each used in different California Supreme Court pension cases (coincidentally, in both cases, the plaintiffs' names are Allen, but they are unrelated).

- "To be sustained as reasonable . . . changes in a pension plan which result in disadvantage to employees **should** be accompanied by comparative new advantages" from 1955's *Allen v. City of Long Beach* (emphasis added).[5]
- "… we have held that any modification of vested pension rights …, when resulting in disadvantage to employees, **must** be accompanied by comparative new advantages" from 1983's *Allen v. Board of Administration* (emphasis added).[6]

The *Marin* appellate court argues that the distinction between *must* and *should* is an important one because "'should' does not convey imperative obligation ... and is 'advisory only and not mandatory.'"[7] The court does not believe that use of the word *must* in the 1983 case was an intentional move by the California Supreme Court to increase the strength of the California Rule or mark "a fundamental doctrinal shift."[8] The appellate court further notes that, while the California Supreme Court has opined only infrequently on the topic of public pensions since the 1983 *Allen* case, when it has, it has used the *should* version of the California Rule rather than the *must* version.[9] Thus, the *Marin* appellate court concludes that it is rejecting other appellate court cases that cited the 1983 *must* version of the California Rule and that, "So long as the Legislature's modifications do not deprive the employee of a 'reasonable' pension, there is no constitutional violation."[10]

If use of the word *should* merely serves as a recommendation, not a requirement, then California obligors may be free to curb spending by reducing pension benefits. However, in our view, a major flaw in

3 Unlike private sector pensions which are regulated by the federal Employee Retirement Income Security Act (ERISA) of 1974, public pensions are exempt from these requirements and have no such unifying oversight. Instead, each state's public pensions are governed by a patchwork of protections that have evolved over time through case law and legislative actions and, therefore, can vary considerably from state to state. See our Nov 2015 piece on pension legal protections, Pension Reforms Are No Cure-All for Problematic Pension Plans for further information on state-specific legal protections.
https://www.gurtin.com/researchDocument/?id=2592.

4 Marin, pg 2.
5 Marin, pg 23 quoting Allen v. City of Long Beach (1955) 45 Cal.2d 128, 131.
6 Id, pg 24 quoting Allen v. Board of Administration (1983) 34 Cal.3d 114, 120.
7 Id, pg 26.
8 Id, pg 26.
9 Id, pg 25.
10 Id, pg 2.

this argument is that, the 1983 case is merely a distraction, a red herring. It is generally accepted that the 1955 original case (using *should*) is what established the California Rule. Amy Monahan, a notable pension law scholar, called the 1955 case a "bombshell" in her review of the California Rule and that case is where the major shift in California's pension laws occurred.[11] Prior to 1955, the prevailing view of public pensions was that employees had the right to a "substantial or reasonable pension" and the court would allow for certain reasonable modifications.[12] It was the 1955 case that established the concept of weighing comparative advantages with disadvantages. Regardless of original word choice or whether the word *must* is considered to yield a stronger sense of obligation, courts have generally been interpreting *should* in an obligatory way ever since the 1955 case, through rejecting pension cuts that did not come with a comparative advantage in case after case. Indeed, the 1983 *Allen* case was merely one in a litany of pension-related cases reviewed by the courts since 1955 and actually focuses on a somewhat unrelated issue, that of whether retirees could obtain increases in benefits from changes that occurred after they ceased to be employees.[13]

What Will the California Supreme Court Do?

While there is a good chance the California Supreme Court will follow its historic precedent and uphold the California Rule given the wealth of case law supporting it, the possibility does remain that the court could uphold the *Marin* case and start to chip away at the rule, so long as the pension remains "reasonable and substantial."

This possibility remains because, unlike the state of Illinois – notorious for its own pension problems and similarly unable to reduce pension benefits after an employee's first day of employment – California has not added a pension protection clause to its state constitution, nor is there a robust repository of recent California Supreme Court cases affirming its stance, as in Illinois. Instead, California's protections are rooted in statute and somewhat dated case law and interpreted under the state and federal contract clauses, which could allow for additional wiggle room.

Indeed, the legality of California's pension protections has been questioned before. Amy Monahan has argued that pensions actually should never have been protected as contracts in California because legal precedent argues that statutes are protected as contracts only with "unambiguous evidence of legislative intent to create a contract"[14] and the California courts have never established this evidence, nor established "the legal basis for finding that a contract exists."[15]

Outside of simply upholding or overturning the ruling, the Supreme Court might take a third approach and limit it to just 20 counties in the state that maintain their own independent retirement systems, known as the Act 1937 counties.[16] The primary issue in the *Marin* case involves the definition of "compensation earnable," which is used to determine an employee's

11 Monahan, Amy. Statutes as Contracts? The 'California Rule' and its Impact on Public Pension Reform. September 26, 2011. Iowa Law Review, Vol. 97, 2012.
12 Id, pg. 1056-1057.
13 Allen v. Board of Administration (1983) 34 Cal.3d 114 , 192 Cal.Rptr. 762; 665 P.2d 534
14 Monahan, pg 1070.
15 Id, pg 1071.
16 The 20 counties that established independent retirement systems under the County Employees Retirement Law of 1937 include Alameda, Contra Costa, Fresno, Imperial, Kern, Los Angeles, Marin, Mendocino, Merced, Orange, Sacramento, San Bernardino, San Diego, San Joaquin, San Mateo, Santa Barbara, Sonoma, Stanislaus, Tulare, and Ventura.

level of pension benefits. Marin County implemented changes to compensation earnable following passage of the California Public Employees' Pension Reform Act (PEPRA) of 2013. While the main part of PEPRA focused on pension changes for new hires, it also contained a small section pertaining specifically to the Act 1937 counties and eliminating the ability for these counties to include uniform allowances, payment for unused vacation days, and other non-salary items in calculating pension benefits.[17] The purpose was to prevent so-called "pension spiking" – a practice that can lead to pension payments being higher than final salaries, and something the Act 1937 counties have become well-known for allowing. [18] Due to legislation passed in 1993, CalPERS (the California Public Employees Retirement System), the administrator of retirement systems for the rest of the counties in the state and most municipalities, had already largely eliminated the practice.

Implications of The Court's Ruling Could Be Felt Far and Wide

Though we believe there is a solid chance the California Supreme Court overturns the *Marin* decision based upon the court's prior opinions, should they uphold the ruling in its entirety the implications could be far-reaching and consequential for the municipal market. While PEPRA intended only to implement moderate changes to pension benefits of current employees in the Act 1937 counties, the appellate court's ruling, if upheld in its entirety, would be applicable to all retirement systems within the state (most notably, behemoths CalPERS and CalSTRS – the two largest pension systems in the nation)[19] and could create massive changes across not only California but also potentially spreading to other states as well. Potential outcomes include:

- Many California localities would likely jump at the opportunity to reduce pension benefits in order to keep their rising pension costs at bay. Since the Great Recession, several years of substantial investment losses and anemic returns have led to significant growth in pension contributions, often outpacing general revenue growth. Just since 2008, for the largest pension plans in the country, required annual pension contributions have grown by nearly 50% when measured as a percentage of payroll (at 18.6% of payroll in Fiscal Year 2015 up from 12.5% in Fiscal Year 2008).[20] For those California municipalities dealing with the combined effects of: state property tax limitations, tax bases that have not recovered well from the Great Recession, and expenditure growth in other areas (e.g. health insurance), a new capability to reduce pension costs would likely be difficult to ignore.

17 Assembly Bill 340 and trailer bill AB 197. The specific changes in question in the Marin case are found in Assembly Bill No. 197, Section 31461.

18 Saillant, Catherine, Maloy Moore, and Doug Smith. Salary 'spiking' drains public pension funds, analysis finds. Los Angeles Times. March 3, 2014. http://articles.latimes.com/2014/mar/03/local/la-me-county-pensions-20120303.

19 Together, CalPERS and CalSTRS (the California State Teachers' Retirement System) cover the majority of public sector employees within California. CalPERS covers state employees, most California cities, counties, and special districts, and school district employees other than teachers. CalSTRS covers teachers at public school districts and community college districts.

20 Munnell, Alicia H and Jean-Pierre Aubry. The Funding of State and Local Pensions: 2015-2020. Center for Retirement Research at Boston College. Number 50, June 2016. http://crr.bc.edu/wp-content/uploads/2016/06/slp_50-1.pdf.

- While the ruling would not be legally binding on other states, given California's standing as the state with the largest two pension plans in the country and as a bellwether on many policy issues, the ruling could provide momentum for change in other states, in particular the 12 states that previously adopted the California Rule, in whole or in part.[21]

- Should the California Supreme Court uphold the lower court ruling as it stands, but not provide a clear definition of what a "reasonable" pension looks like, we would expect to see significant further litigation to attempt to define the notion of what a "reasonable" pension is and how far cuts can go before hitting the point of "reasonableness." An alternate possibility would be that the California Supreme Court leaves this up to the General Assembly to decide, leading to a confluence of public interest groups lobbying the General Assembly to arrive at a definition.

No matter the outcome, the California Supreme Court's ruling will provide needed clarity on this issue and will serve as either a daunting obstacle to pension reform efforts or an invitation to obligors to reduce pension liabilities. If the appeals court ruling is upheld, this added available flexibility may prove especially beneficial to obligors in the future, as we expect that – despite recent rebounds in the stock market – pension plans will continue to struggle to climb toward full funding levels given aggressive expectations for investment returns that dramatically exceed actual recent returns. As always, we will continue to closely monitor the *Marin* case and the overall pension environment to ensure our clients are well protected.

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Share the report:

Analysts:

Emily Robare
Vice President
erobare@gurtin.com

Thomas Schuette
Co-Head of Investment Research & Strategy
tschuette@gurtin.com

21 The 12 states include Alaska, Colorado, Idaho, Kansas, Massachusetts, Nebraska, Nevada, Oklahoma, Oregon, Pennsylvania, Vermont, and Washington. Monahan, pg. 1071.

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