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PERSPECTIVE

California Rule and public retirement system governance

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By all indications, 2020 will be the year in which the California Supreme Court speaks again on the scope of the “California Rule.” The question at the top of many minds in the public pension arena is whether the court will make substantial changes to the rule and, if so, what these changes will be. The court has not yet indicated what it may say on that topic when it rules in the remaining four cases pending before it that allege violations of the California Rule. Meanwhile, two interrelated current issues important to public retirement system governance are being addressed in other California state court litigation. Those other issues — corrections of benefit errors and improvements in system operations — may well be impacted by the Supreme Court’s guidance on the scope of the California Rule, and they, too, warrant attention.

First, some terminology. “The California Rule” is a term used to describe a judicial doctrine that has developed in the state over more than half a century that provides contracts clause-based protection of a public employee’s right to continue accruing retirement benefits on the same or better terms during their future public employment as they did during their prior years of qualifying public employment. This rule, also adopted in a number of other states, is premised on the view that retirement benefits provided through legislation or similar governmental action are a form of deferred compensation promised by the employer and thus are a part



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of the employment contract of the employee.

In March 2019, the California Supreme Court issued its first decision in five cases before it that challenge the constitutionality of various parts of the state legislature’s Public Employees’ Pension Reform Act of 2013 (PEPRA) and related changes to statutes governing the State and county public retirement systems as provided in Assembly Bills 340 and 197 (2012) (collectively, “AB 197”). In that case, *Cal Fire Local 2881 v. California Public Employees’ Retirement System*, 6 Cal. 5th 965 (2019), the court provided a comprehensive analysis of the predicates necessary to determining whether a particular employment or pension benefit is a “vested” contract right, and therefore constitutionally protected, under California law. The *Cal*

Fire court unanimously concluded that “California’s public employees have never had a contractual right to the continued availability of the opportunity to purchase [Additional Retirement Service, or ‘ARS’] credit.” Accordingly, the court stated that its decision “expresses no opinion on the various issues raised by the state and amici curiae relating to the scope of the California Rule.”

In *Cal Fire*, the court considered the constitutionality of a PEPRA provision that eliminated the authority of both the state (through the California Public Employees Retirement System (aka “CalPERS”)) and local public agencies — such as counties and cities operating under the Public Employees Retirement Law (PERL) and other counties that operate under the County Employees Retirement Law of 1937 (CERL) — to grant

their employees the right to purchase ARS as a means to increase their future public retirement allowances received from the retirement systems in which they are members. As noted, the right the California legislature eliminated applies only to current public employees’ potential future purchases of ARS. Also, the *Cal Fire* court also observed that “unlike core pension rights, the opportunity to purchase ARS credit was not granted to public employees as deferred compensation for their work.”

Nevertheless, the *Cal Fire* court permitted the legislature to eliminate a right that the state, and some counties and cities, previously had granted their employees that directly impacted those employees’ future potential retirement allowance amounts. Because the *Cal Fire* court concluded that the contracts clause did not protect a future right to purchase ARS, it did not deem that equitable considerations warrant the invocation of estoppel to prevent the legislature, (or by extension a public employer and/ or public retirement board), from eliminating that right prospectively. The court also expressly did not assess the extent to which the PEPRA change was a reasonable modification of law consistent with the “successful operation of a public retirement system,” or whether, since the change was detrimental to the rights of certain current public employees, any “comparable new advantages” should be provided to those employees, as a court would analyze under California Rule-based precedent.

What’s next on the horizon for the California Rule? Now that the Supreme Court has decided *Cal*

Fire, the next case in line regarding the constitutionality of another PEPRA-related statutory change is *Alameda County Deputy Sheriff's Assn. v. Alameda County Employees' Retirement Assn., et al.*, S247095. *Alameda* is a consolidated proceeding involving three county retirement systems that operate under CERL. In short, the plaintiffs in these cases challenge provisions in AB 197 that preclude county retirement systems from prospectively including certain types of compensation in public employees' retirement allowance determinations, as a violation of the contract clauses in the state and federal constitutions.

In response, one retirement system respondent took the position in briefing before the Supreme Court that, similar to *Cal Fire*, active county retirement system members did not have a constitutionally protected contractual right to include in their pension calculations the specific types of compensation the legislature decided must or could be eliminated from future "compensation earnable" determinations by CERL retirement boards. The other two retirement system respondents argued that equitable estoppel is an improper legal basis upon which to force retirement systems to continue including those compensation types in future determinations of compensation earnable, assuming the legislature was constitutionally permitted to exclude them from compensation earnable determinations in the first place.

Thus, just as the *Cal Fire* decision did not address the scope of the California Rule, we submit that if the court agrees with the retirement board respondents on the manner in which the California Rule applies and/or limits the applicability of estoppel with respect to "compensation earnable" determinations, that *Alameda*

need not either. But, even if *Alameda* does not impact the scope of the California Rule, the case may have substantial ramifications for at least two related topics of importance to California public retirement system governance.

Related topic no. 1: Retirement System Correction of Errors.

California courts of appeal consistently have permitted public retirement systems that discover they are paying higher retirement benefits than is permitted by statute to correct those payments prospectively. The most recent of those decisions was issued just last year in *Blaser v. STRS*, 37 Cal. App. 5th 349 (2019).

Blaser affirms the legal authority of public pension systems to correct ongoing errors in the payment of benefits, even if the retirement system discovered those errors more than three years before correcting them. The court in *Blaser* noted, however, that, "[o]n remand, the trial court may, upon request, address whether [Teacher Plaintiffs] are entitled to assert laches and/or estoppel, and, in the event it determines Teachers may do so, whether laches and/or estoppel serve as a bar to the assertion by CalSTRS of claims related to overpayments." Thus, the court left open the possibility that even though CalSTRS' correction was not barred by the statute of limitations, a trial court may invoke equitable principles of estoppel or laches to prevent the correction retroactively and/or prospectively. While the plaintiffs' arguments in *Blaser* were not grounded in the California Rule, the estoppel argument may well be impacted by how the Supreme Court addresses that topic in *Alameda*.

Related topic no. 2: Retirement Board Attempts to Improve System Operations

The California Supreme Court and courts of appeal have historically upheld retirement boards' attempts to modernize and improve system operations, whether through their adjustments of actuarial assumptions in a manner that increases member contributions due to the retirement system [*Internat'l Ass'n of Firefighters v. City of San Diego*, 34 Cal. 3d 292 (1983)] or through member reclassifications that impact their future retirement benefit accrual rights [*Crumpler v. Board of Administration*, 32 Cal. App. 3d 567 (1973)]. Percolating through court of appeal decisions, however, is the question of whether equitable considerations of either estoppel, laches, or both, could successfully be invoked to prevent retirement boards from, in their judgment, improving the sound operation of the retirement system on a prospective basis by making changes applicable to current active members of the retirement system. A question raised by *Alameda* is whether such potential future changes to improve system operations also may include a board's

determination to exclude certain types of non-"core" pay items — on the theory that their inclusion in retirement allowance calculations is not protected by the contracts clause.

The California Supreme Court may well decide the contours of the California Rule in the coming year, but its decision in *Alameda* and the other pension cases set for review will also provide guidance on governance issues critical for public pension boards. The California Constitution expressly affords public retirement boards "plenary authority, consistent with their fiduciary responsibilities," to administer the retirement systems they govern. What does that express grant of authority and discretion mean, if not to permit them to correct errors and improve operations within the retirement system, after a careful balancing of short and long-term interests of their members and beneficiaries? No doubt the Supreme Court's guidance on these topics will be critical to the next decade of public retirement system governance in California. ■

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