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Cal Fire! The California Supreme Court Singes the 'Vested Rights' Doctrine

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Public school teachers, police, firefighters, and other state and local government employees accept their jobs with the understanding that their relatively low salaries are backed up by excellent pension benefits. In July 2019, Moody's Investors Service estimated that U.S. public pensions are underfunded by $4.4 trillion. U.S. public pension underfunding is larger than the economy of most developed countries. For example, Germany, the world's fourth largest economy, is expected to produce $4.2 trillion in 2019 as measured by its gross domestic product. The $4.4 trillion dollars in public pension underfunding is

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also so large that it equals one fifth of the $22 trillion in U.S. national debt.

Compounding the problem of out-of-control costs is that governmental plans are lightly regulated. Congress exempted itself and other employee benefit plans sponsored by governmental employers from the rigors of complying with the Employee Retirement Income Security Act of 1974 (ERISA). This "comprehensive and reticulated statute" regulates most aspects of employee benefit plans in the private sector. Although ERISA contains cradle-to-grave regulations for qualified retirement plans in the private sector, it does not contain any vesting or funding rules for public sector retirement arrangements.[1]

In February 2011, California's Little Hoover Commission, an independent oversight agency, wrote to Governor Jerry Brown, stating:

> California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking, and an unwillingness to plan prudently. Unless aggressive reforms are implemented now, the problem will get far worse, forcing counties and cities to severely reduce services and lay off employees to meet pension obligations…
>
> The state must exercise its authority—and establish the legal authority—to reset overly generous and unsustainable pension formulas for both current and future workers.[2]

The report found that local governments:

> [F]ace the prospect of increasing required contributions into their pension funds by 40% to 80% of their payroll costs for decades to come. It is practically enough money to fund a second government, and it will—a retired government workforce. . . ."
>
> Public employees also share in the prospect of a very different California, as cities such as Los Angeles, San Diego, San Francisco, and San Jose prepare to spend one third of their operating budgets on retirement costs in coming years. Pensions are at the center of what will be an intensifying fight for diminishing resources from which government can pay for schools, police officers, libraries, and health services.[3]

The Hoover Commission concluded: "The math doesn't work." . . .

> Payroll growth—in terms of both compensation for public employees and the number of employees—has ballooned pension liabilities. The minimum retirement age has dropped to 55—earlier,

> for public safety employees—as people live longer, creating an upside-down scenario where governments potentially will send retirement checks to an employee for more years than they earn paychecks. At the same time, state and local governments have increased what used to be considered a good pension into pensions that are the most generous in the country.[4]

THE CALIFORNIA TIME BOMB

California's public pension debt was reported to be $1.052 trillion in 2017, the last year of complete data. Recently reported public pension accounting reports indicate public pension debt is now more than $1.109 trillion. California's pension debt per household is more than $81,000.

The terms and conditions of public employment in California are in general controlled by statute or ordinance rather than by contract.[5] Nevertheless, "[u]nlike other terms of public employment, which are wholly a matter of statute, pension rights are obligations protected by the contract clause of the federal and state Constitutions." The United States and the California Constitutions prohibit the impairment of contractual rights. Article I, Section 10, of the U.S. Constitution states: "No state shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility." The California Constitution similarly states at Article I, Section 9, "A bill of attainder, ex post facto law, or law impairing the obligation of contracts may not be passed."[6]

In the seminal case of *Kern v. City of Long Beach*,[7] the California Supreme Court reversed course from *Pennie v. Reis*[8] and announced:

> [P]ublic employment gives rise to certain obligations which are protected by the contract clause of the Constitution, including the right to the payment of salary which has been earned . . . . Since a pension right is an 'integral portion of contemplated compensation'. . . it cannot be destroyed, once it is vested without impairing a contractual obligation.[9]

The *Kern* case involved unusual facts. Mr. Kern had been a member of the city of Long Beach's Fire Department for 19 years and 11 months. When he began working as a firefighter, the city had a provision in its charter that provided a pension for firefighters equal to 50 percent of their annual salary after completing 20 years of service. For 15 years of his service, 2 percent of Mr. Kern's salary had been deducted and paid into the pension fund. On March 29, 1945, 32 days before Mr. Kern completed the required 20 years' service,

a new section was added to the city charter repealing the pension provisions and eliminating pensions for all persons not then eligible for retirement.[10] Upon completing his 20 years of service, Mr. Kern requested that he be retired and paid a pension. The city refused and Mr. Kern filed suit.[11] The Supreme Court in *Kern* decided that Mr. Kern's right to his pension benefits vested upon his acceptance of employment.[12]

The Supreme Court, while recognizing the unilateral nature of a public employee's pension rights, did not make them unchangeable:

> Thus it appears, when the cases are considered together, that an employee may acquire a vested contractual right to a pension but that this right is not rigidly fixed by the specific terms of the legislation in effect during any particular period in which he serves. The statutory language is subject to the implied qualification that the governing body may make modifications and changes in the system. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension. There is no inconsistency therefore in holding that he has a vested right to a pension but that the amount, terms, and conditions of the benefits may be altered.[13]

The Supreme Court concluded that Mr. Kern had a vested pension right and that the city of Long Beach, by completely repealing his pension, had improperly attempted to impair its contractual obligations.[14]

A more modern and refined version of this "vested rights" doctrine was set forth by the California Supreme Court in the leading case of *Betts v. Board of Administration*:

> A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity [*citing Kern*]. The employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a "substantial or reasonable pension."[15]

In summary, "[b]y entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer."[16]

Under *Kern* and its progeny, determining whether a particular change to retirement benefits impairs a vested right involves a two-step inquiry. The first question is whether the change actually alters the contract between the employer and the employee. If it does, the next question is whether the change constitutes a reasonable modification.

LOOKING AT THE TERMS OF THE CONTRACT

In California, whether a proposed change impairs a vested right under a public pension plan depends upon how the member's rights are defined under the terms of the governing "contract."[17] Thus, the nature and extent of a member's vested right to a retirement benefit must be ascertained from the language of the statute and other legally operative documents such as resolutions implementing the retirement plan.[18]

The case law bears out the conclusion that the scope of a member's vested right is defined by the terms of the promise. For example, the California Supreme Court has held that if a member's contribution rate under a pension plan is fixed and the pension plan does not give the plan sponsor the right to change the rate, any increase in that rate would constitute an impairment.[19] In contrast, where the plan terms state that a member's contribution rate is subject to adjustment based upon actuarial assumptions, an increase in the member's contribution rate attributable to changes in such actuarial assumptions is not an impairment.[20]

CAL FIRE AND THE AIRTIME CONTROVERSY

In 2003, the California legislature enacted Government Code Section 20909. It allowed eligible members of the California Public Employees' Retirement System (CalPERS) to purchase up to five years of nonqualifying service credit. This optional benefit is commonly referred to as "airtime."

Fast-forward 10 years later, the California Legislature reversed course by enacting the California Public Employees' Pension Reform Act of 2013 (PEPRA).[21] The PEPRA eliminated airtime. This change, however, only applied prospectively. Any CalPERS member who had exercised their option to purchase airtime retained it.

In *Cal Fire Local 2881 v. California Public Employees' Retirement System*,[22] the Cal Fire plaintiffs argued that "airtime" benefits were vested rights protected from change by the California Constitution's Contract Clause.[23] That clause restricts the power of states to enact laws affecting a "substantial impairment of contracts, including contracts of employment."[24] The vested rights doctrine in California has evolved into the following: (1) a public employee's contract is formed and vests as of the first day of employment; (2) any proposed disadvantages to the pension contract must be offset by comparable new advantages; and (3) the pension contract protects not only what an employee has earned, but also what he or she might possibly earn in the future.[25]

The Cal Fire plaintiffs pointed to *Retired Employees Association of Orange County, Inc. v. County of Orange*,[26] as support for its position that airtime was a vested right.[27] The *Orange County* case presented the question of whether retiree medical benefits that had been provided through a series of express collective bargaining agreements were protected by the vested rights doctrine. In *Orange County*, the Supreme Court found the existence of collective bargaining agreements critical to its conclusion that an implied contractual and vested right could have been created.[28] "Where the relationship is governed by contract, a county may be bound by an implied contract (or by implied terms of a written contract) as long as there is no statutory prohibition against such an agreement."

In rejecting the Cal Fire plaintiffs' claim that "air rights" were protected, the California Supreme Court stated:

> It was critical to Retired Employees' holding that the legislative enactment on which the implied contractual rights were premised was a resolution approving an express contract of employment. *Id*. at 1187.
>
> The County Board's ratification of this contract provided the requisite clear manifestation of intent to create contractual rights. Nothing of the sort occurred in connection with the opportunity to purchase ARS credit. The Legislature did not engage in any sort of negotiation with the public employees covered by Section 20909, let alone ratify an express or implied contract reflecting its terms. The Legislature simply enacted a statute granting the opportunity to purchase ARS credit. As *Retired Employees* noted, such statutes, which announce a policy rather than create a contract, "are inherently subject to revision and repeal." *Retired Employees*, *supra*, at p. 1185.[29]

State law does not normally create contractual rights but "merely declares a policy to be pursued until the legislature shall ordain otherwise."[30]

In *Cal Fire*, a unanimous California Supreme Court held that "air time" was not entitled to constitutional protection.

> We conclude that the opportunity to purchase ARS credit was not a right protected by the contract clause. There is no indication in the statute conferring the opportunity to purchase ARS credit that the Legislature intended to create contractual rights.[31]

The Supreme Court explained that the terms and conditions of public employment are ordinarily considered to be statutory rather than contractual. They are subject to modification at the discretion of the governing legislative body.[32]

> Constitutional protection can arise, however, (1) when the statute or ordinance establishing a benefit of employment and the circumstances of its enactment clearly evince an intent by the relevant legislative body to create contractual rights or, (2) when, even in the absence of a manifest legislative intent to create such rights, contractual rights are implied as a result of the nature of the employment benefit, as is the case with pension rights.[33]

Although public employees may hold implied vested contractual rights that are tied to the performance of service, the Court found that the air time benefit was not connected to any actual service. The option for air time was not a contractually binding offer. Air time did not induce any employee to work for the state. Pension benefits, the classic example of deferred compensation, are tied directly to a public employee's service, and their value directly relates to how long the employee works for the state. There was no basis on which the Court could conclude that the opportunity to purchase air time was granted in exchange for an employee's service, prior to the employee's election to purchase the service credit. The amount of air time was simply a matter of employee choice. It had no relationship to any requirement that the employee work for a certain amount of time for the state.

The Court explained that "[w]e have never held, however, that a particular term or condition of public employment is constitutionally protected solely because it affects in some manner the amount of a pensioner's benefit . . . a term and condition of public employment that is otherwise not entitled to protection under the contract clause does not become entitled to such protection merely because it affects the amount of an employee's pension benefit."

Because the Court held that the opportunity to purchase air time was not a vested contractual right, it did not reach the issue of whether PEPRA's elimination of the air time benefit unconstitutionally impaired the contractual rights of public employees. The Court thus sidestepped the California vested rights question—for now. Two cases squarely presenting the vested rights question are pending before the California Supreme Court.[34]

WHAT IS NEXT?

In February 2011, the Little Hoover Commission made four recommendations to California legislatures:

1. To reduce growing pension liabilities of current public workers, state and local governments must pursue aggressive strategies on multiple fronts.

2. To restore the financial health and security in California's public pension systems, California should move to a "hybrid" retirement model.

3. To build a sustainable pension model that the public can support, the state must take immediate action to realign pension benefits and expectations.

4. To improve transparency and accountability, more information about pension costs must be provided regularly to the public.

In 2012, then Governor Jerry Brown attempted to follow the Little Hoover Commission's advice and proposed a number of significant changes to the laws governing California's public pensions. As noted above, the legislature did approve the elimination of "air time." The legislature also raised the age for retirement with full pension benefits from 50 to 57 for newly hired public safety workers and from 55 to 67 for newly hired civil servants. It also required minimum contributions from employees toward their pensions to supplement the much-larger taxpayer funded contributions. These changes applied to most employees of the state, counties, cities, and local districts. Excluded from these changes were employees of the University of California and cities like San Francisco, Los Angeles, San Diego, and San Jose, which manage their own pension systems. Governor Brown's proposal to start a new hybrid pension system was rejected. In its place, the legislature approved a cap on the salary that could be used to calculate employee pensions. The current cap is $117,020 for workers who participate in Social Security and $140,424 for those who do not.

One thing is certain, the problem of public pension debt keeps getting bigger. Between January 2011 when Governor Brown retook the office of governor and January 2019 when he left, California's annual bill for retirement obligations reached $11 billion—nearly double what it was in 2011. Since the legislative changes in the 2012 law apply mainly to newly hired employees, savings have trickled in slowly. The question is not really whether California's pension debt will explode over the next 10 years, the real question is whether California's leaders will have the courage to save California's public pension system.

NOTES

1. ERISA § 4(b)(1), 29 U.S.C. § 1003(b)(1).

2. *Id.*, p. 53.

3. *Id.* at (iii).

4. *Id.* at p. (iv).

5. *See Miller v. State of California*, 18 Cal.3d 808, 813 (1977) ("It is well settled in California that public employment is not held by contract but by statute.")

6. *United Firefighters of Los Angeles City v. City of Los Angeles*, 210 Cal.App.3d 1095, 1102 (Ct. App. 1989).

7. *Kern v. City of Long Beach*, 29 Cal.2d 848 (1947).

8. Pennie v. Reis, 132 U.S. 464 (1889).

9. *Id.* at 853.

10. *Id.* at 850.

11. *Id.*

12. *Id.* at 852.

13. *Id.* at 855.

14. *Id.* at 856.

15. *Betts v. Board of Administration*, 21 Cal.3d 859, 863 (1978).

16. *Carman v. Alvord*, 31 Cal.3d 318, 325 (1982) (*citing Betts*), and to earn additional pension benefits pursuant to improved terms conferred during continued employment. *See Betts*, 21 Cal.3d at 866 ("An employee's contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee's subsequent tenure"). This means that the employee has a vested right not merely to preserve the pension benefits already earned, but also to continue to earn benefits under the terms previously promised through continued service. *See Legislature v. Eu*, 54 Cal.3d 492, 530 (1991) ("We conclude that incumbent legislators had a vested right to earn additional pension benefits through continued service"); *see also Pasadena Police Officers Assoc. v. City of Pasadena*, 147 Cal.App.3d 695 (Ct. App. 1983) ("the employee has a vested right not merely to preservation of benefits already earned pro rata, but also, by continuing to work until retirement eligibility, to earn the benefits, or their substantial equivalent, promised during his prior service").

17. *See Int'l Ass'n of Firefighters v. City of San Diego* 34 Cal.3d 292, 302 (1983).

18. (*see, e.g., Id.* at 302 (looking to city charter and ordinance); *Ventura County Retired Employees' Ass'n v. County of Ventura*, 228 Cal.App.3d 1594, 1598–1599 (Ct. App. 1991) (looking to the Government Code to determine an employer's obligations), *rev. denied*, 1991 Cal. Lexis 3034 (1991); *Orange County Employees' Ass'n, Inc. v. County of Orange*, 234 Cal.App.3d 833, 843–844 (Ct. App. 1991) (looking to the Government Code), *rev. denied,* 1991 Cal. Lexis 5658 (1991); *Thorning v. Hollister School. Dist.*, 11 Cal.App.4th 1598, 1607–1608 (Ct. App. 1992) (looking to official declaration of policy issued pursuant to Government. Code); 2000 Cal. AG Lexis 3 (Jan. 28, 2000) (benefits provided pursuant to city resolution adopted under Government Code)), and judicial construction of those provisions or similar provisions at the time the contractual relationship was established. *Kern*, 29 Cal.2d at 850, "[I]t is necessary to perceive the terms of the contract and to utilize those terms to measure the claimed impairment." *Lyon v. Flourney*, 271 Cal.App.2d 774, 783, (Ct. App. 1969), appeal dismissed, 396 U.S. 274 (1970).They are the reasonable expectations of the employee that are protected. *See generally Allen v. Bd. of Admin.*, 34 Cal.3d 114 (1983); *see also Ass'n of Blue Collar Workers v. Wills*, 187 Cal.App.3d 780, 792 (Ct. App. 1986) (right vested in employees is their "reasonable expectation" that the city would meet its statutory obligation to fund past-service liability).

19. *See generally Allen v. City of Long Beach*, 45 Cal.2d 128 (1955); *see also Abbott v. City of Los Angeles*, 50 Cal.2d 438, 451–453 (1958) (changes, including imposition of member contributions where plan provisions previously required full cost to be paid by employer, held invalid); *Wisley v. City of San Diego*, 188 Cal.App.2d 482, 486 (Ct. App. 1961) ("It is obvious that the increase in the percentage of the employee's contribution to the retirement fund is a detriment").

20. *See Int'l Ass'n of Firefighters*, 34 Cal.3d at 300, 302-303; *see also Pasadena Police Officers Ass'n*, 147 Cal.App.3d at 711 (because the authority of the retirement Board to adopt and approve actuarial assumptions was a condition of entitlement to benefits at all times, the decision of the Board in the exercise of that authority to use an assumption as to salary inflation in calculating contributions did not deprive members of vested rights); *accord Walsh v. Board of Admin.*, 4 Cal.App.4th 682, 700 (Ct. App. 1992) ("If the modification of Walsh's retirement benefits was consistent with the reservation of power to the Legislature, then it was valid regardless of whether the [retirement system] can be said to have granted contractual rights to members of the Legislature").

21. Government Code § 7522 *et seq.*

22. *Cal Fire Local 2881 v. California Public Employees' Retirement System*, 6 Cal.5th 965 (2019).

23. *Id.* at 971.

24. *Allen v. Board of Administration* (1983), 34 Cal.3d 114, 119 (1983).

25. *Allen v. City of Long Beach*, 45 Cal.2d 128, 131 (1955).

26. *Retired Employees Association of Orange County, Inc. v. County of Orange*, 52 Cal.4th 1171 (2011).

27. *Cal Fire, supra* n.22 at 980–981.

28. *Orange County, supra* n.26 at 1133.

29. *Id.* at 981.

30. *National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co.*, 470 U.S. 451, 465–466 (1985).

31. *Id.* at 970–971.

32. *Id.*

33. *Id.* at 970.

34. *Marin Ass'n of Public Employers v. Marin County Employees' Retirement Ass'n.*, 2 Cal.App.5th 674 (2016), *Alameda County Deputy Sheriff's Ass'n v. Alameda County Employees' Retirement Ass'n*, 19 Cal.App.5th 61 (2018).