The California Rule and Its Potential Abolition

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MERCATUS WORKING PAPER

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Scott Andrew Shepard. "The California Rule and Its Potential Abolition." Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2018.

Abstract

California faces a significant pension-funding crisis. It has increased government-worker pension benefits repeatedly since the 1980s. Meanwhile, a California Supreme Court doctrine—the California Rule—has been understood to forbid cutting benefits for any currently employed government workers, even for work they have not yet performed. The state has also maintained a high discount rate (i.e., an assumed investment-return rate) in the teeth of the recessions and low interest rates. The result has been consistent and now parlous underfunding. A trio of cases awaits California Supreme Court consideration. In each of these cases, the circuit courts have concluded that the common interpretation of the California Rule is incorrect, though they disagree sharply about the real content of that rule. This paper proposes that the Supreme Court follow the circuit courts in permitting cuts to benefits not yet earned and careful cuts to benefits already earned in narrow cases.

JEL codes: H10, H11, H12, H3, H550, H71, H72, H74, H75, H77, J5, J58, K1, K12, K31

Keywords: pension reform, public pensions, state finances, government finance, public employees, public-employee unions, government employees, government-employee unions, tax-base flight, employee benefits, public choice theory, government oversight, fringe benefits, Contract Clause, California Rule, state constitutional law

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This paper can be accessed at https://www.mercatus.org/publications/state-and-local-policy/california-rule-abolition-pensions.

The California Rule and Its Potential Abolition

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Introduction

The California Rule, or its equivalent, has proved a challenge to the numerous states that have adopted it. The rule, as commonly understood, forbids the state from reducing pension benefits once they have been offered at any point during the tenure of a worker employed at the time the offer was made.

This rule does not comport with contract law or quasi-contract equity and does not spring from any coherent interpretation of the federal Contract Clause. The flaws in the California Rule have been demonstrated in recent years. California, among other states, has promised far more in pension benefits than its taxpayers have proved willing (or possibly able) to pay, and while many parties broadly agree that a first step toward remedy would be to start reducing future benefits not yet earned by current or future employees, the rule has stood in the way.

In the wake of practical necessity has come a wave of revisionist argument. According to these claims, the California Rule has been misunderstood all along. It does not really forbid all net reductions in benefits for current workers (and possibly some retirees) but permits them—sometimes. Accord has not been reached among the analysts, however, who now include the California appellate courts and the administration of Governor Jerry Brown, as well as a bevy of independent sources, as to just when and under what conditions such reductions may be made.

This paper constitutes an attempt to answer the question of when and under what conditions benefits to current workers and retirees can be reduced without corresponding benefits being offered. It concludes that the answer to the question is to divide such benefits into three types. The first of these types, benefits that have already been earned for work already done, is the most protected type of benefits and can only be reduced with the most careful scrutiny and under only a narrow set of justifications, including real or constructive fraud against the taxpayer or explicitly proven financial necessity. The second type of benefits is those that have not been earned but have been explicitly contracted to continue until some certain date. Reduction of these benefits should receive significant scrutiny, though they may perhaps be invaded under conditions that are less strictly restricted than the first type of benefit. The third type of benefits is those that have not yet been either earned or contracted. These benefits—for which no promises have been made by the civil power and which constitute at law and in equity not obligations but only the hopes of current employees—deserve no particular protection and may be reduced without any Contract Clause–based oversight of any kind. This third category of benefits is a large one, as it encompasses all work that will be performed by all current workers after their current contracts or collective bargaining agreements—if any—end.

The California Supreme Court will in the coming months be hearing appeals of three decisions of the circuit courts and will have the opportunity to explain what it has really meant in its precedent or even to abandon previous positions as error and state new ones. However it styles its decision, it should embrace the tripartite structure elaborated in this paper. The structure gives full respect to all of the relevant interests involved in the review of pension promises: insulation of government-worker contract rights, respect for the legislative power of the state to make laws about its future actions, protection of taxpayers against overgenerous and insupportable grants of benefits by government employees to government employees and their representatives, and recognition of the state's need to maintain its solvency in the face of limits to taxpayer willingness and ability to pay its obligations.

The first section of this paper reviews the content and development of the California Rule as generally understood. The next section reviews the cases that now wend their way toward the California Supreme Court and the Brown administration's intervention in them. The paper then suggests a model of how the California Supreme Court should decide these cases and the content that any "new California Rule" should take. This section expands on the tripartite structure outlined above. The paper's last section predicts the developments that will follow a happy decision by the court in these matters.

How the California Supreme Court decides these cases and refines the California Rule will have a significant effect on California's future. A thoughtful and careful definition or revision of the California Rule may also have significant nationwide implications—especially in some of the states joining California in facing the most serious pension-funding crises.[1]

The Crisis

California, along with a number of other American states, faces a severe and in many ways crippling government pension-funding crisis. By the state's own current calculations, it now has more than $250 billion in unfunded pension liabilities, and that figure is growing.[2] The state was obliged to dedicate 6.5 percent of its general-fund spending in 2016–2017 to pension funding, more than triple the figure that it spent in 2002–2003, and it is still rising.[3] This represents a significant budget item by any estimate, but it has a far greater practical impact on

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[1] *All Eyes on California Court System as It Weighs Pension Benefit Cases*, PENSIONS & INVESTMENTS (Jan. 22, 2018) ("Such is California's status that an affirmative ruling would also likely influence courts and legislatures in other states with similar prohibitions on the reduction of promised benefits for public employees."). The decisions of the California Supreme Court have no precedential effect in other states, but its rulings often carry influence beyond its borders.
[2] *See, e.g.*, Judy Lin, *Understanding California's Public Pension Debt: The Gap Between Money Available and Promises Made Is Huge and Growing*, L.A. TIMES (Sept. 18, 2016) ($241.3 billion in 2014).
[3] *See* Joshua D. Rauh, *Can California Save Itself from a Pension Disaster?*, 1801 EUREKA (THE UNSTATED STATE OF THE NATION-STATE) (Jan. 25, 2018).

the budget than is initially apparent. Because of obligations attached to federal grants to the state, unfunded federal mandates, sequesters established by California voters in initiatives, and other restrictions, only 12 percent of California's general-fund budget is "discretionary" or nonmandatory, down from 21 percent six years ago.[4] The rapid increases in pension liabilities over the last 15 years have been a primary driver in constraining California's spending, government services, and options.[5]

As bad as things are at the state level, they are worse for municipalities. A significant League of California Cities study recently revealed, among other disheartening details, that "between FY [fiscal year] 2018–19 and FY 2024–25, cities' dollar contributions" to CalPERS, to pay for pension promises, "will increase by more than 50 percent. For example, if a city is required to pay $5 million in FY 2018–19, the League expects that it will pay more than $7.5 million in FY 2024–25."[6] While the pain will not spread evenly, it will flow everywhere. No cities face increases of less than 20 percent over the next few years, while some will face

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[4] David Crane, *For Whom the California Budget Tolls*, FOX & HOUNDS (Jan. 10, 2018). As Crane explains in detail,

> Assume General Fund revenues this fiscal year are $100. The first $40 plus unpaid balances (if any) goes to K-14 education as a result of constitutional protection (Proposition 98). The next $7 goes to General Obligation bond debt service as a result of constitutional and contractual protection and another $7 goes to pensions and retiree healthcare as a result of contractual protection. . . . Medi-Cal, a statutory entitlement, takes 15% of the General Fund (plus additional amounts from Special Funds) and another 7% is consumed in part by entitlements administered by the Department of Social Services. Together, those protected obligations (ie, K-14, debt service, pensions, OPEB, Medi-Cal and DSS) will consume 78% of the General Fund this fiscal year, up from 69% just six years ago.
>
> That leaves only 22% (ie, 100–78) for everything else, but that 22% must also cover Corrections, CHP and CalFire, all involving public safety and politically protected by powerful government employee unions. Public safety takes 10+% of the General Fund, leaving only 12% for UC, CSU and other discretionary categories not protected by contract, statute or the constitution. That's down from 21% just six years ago; ie, the share of the General Fund available for discretionary items declined 43% in just six years.

[5] *Id.*

[6] *Retirement System Sustainability Study and Findings*, LEAGUE OF CALIFORNIA CITIES, 4 (Jan. 2018).

increases in excess of 60 percent.[7] These massive increases come on top of a baseline that has already grown approximately fourfold in the past 15 years.[8]

Meanwhile, these figures, however grim, still represent an overly rosy scenario. They are reached using the state's assumed discount rate of 7 percent.[9] This rate is an unrealistically high return assumption for current financial conditions and has been for some time.[10] In fact, it is generally agreed among economists that it is the wrong measure entirely.[11] Rather than guessing what returns the state might happen to make in the market in any given year, depending on how its risky investments pan out, the state should be matching its current "wind-up" pension obligations (i.e., what it would owe if it shut down its pension today and paid everyone what it currently owes, when it owes it) against its current saved pension assets discounted by the risk-free federal Treasuries rate. As Joshua Rauh, the chief exponent of this calculation method, has

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[7] *See id.* The year 2018 rang in with an explosion of local news articles about extensive increases in pension-funding costs throughout the state's municipalities and the struggles of those municipalities to continue to provide a minimum level of services to citizens. There were, in fact, far too many articles to cite here.

[8] *See, e.g.*, Joe Nation, *Pension Math: Public Pension Spending and Service Crowd Out in California, 2003–2030* (Stanford Institute for Economic Policy Research, Working Paper No. 17-023, Oct. 2, 2017). This is a highly informative study, containing additional depths of information about the wide, negative effects of pension overpromising in California.

[9] The discount rate is, in effect, the rate that the state assumes it will earn on the money that it has saved in order to pay off future pension benefits.

[10] *See, e.g.*, Scott Andrew Shepard, *The Lead Lemming: Illinois on the Pension Crisis Brink*, 14 J. L. PUBL. POL'Y 151 (2018) § I (*available at* https://ssrn.com/abstract=2921474) ("Because the rate-of-return includes a return for inflation, this discount rate is a nominal rate (i.e., it includes both the real return on investment and the result of inflation). When inflation is perceived as being particularly low, as it has been since 2008, nominal rates of return fall precipitately below historical averages. If pension funds assume a discount rate based on historical averages, this assumed discount rate proves not only irrelevant but straightforwardly disastrous: relying on it results in the sort of underfunding multiplication described in the text above."). *See also* citations in note 11.

[11] *See, e.g.*, Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSPECTIVES 191, 193, 195, and *passim* (2009) (risk-free rate most appropriate, matched against the present value of the liabilities, known as the "accumulated benefit obligation"); John A. Turner et al., *Determining Discount Rates Required to Fund Defined Benefit Plans* (Mar. 2015), *available at* http://www.actuaries.org/oslo2015/papers/PBSS-Turner&GO&McC&B-P.pdf (preferred "rule would be to select a discount rate that is less than the expected rate of return on assets but greater than the risk free rate, with the discount being greater the higher the percentage of the portfolio invested in equity and the longer the duration of the liabilities"); Alicia H. Munnell, *Appropriate Discount Rates for Public Plans Is Not Simple*, MARKETWATCH.COM (Oct. 5, 2016) (6 percent). *See also* Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FINANCE 1211 (2011) (determining public debt using accumulated benefit obligation method); Alicia H. Munnell et al., *The Funding of State and Local Pensions 2012–2016* (Ctr. for Retirement Research at Boston Coll., Issue In Brief No. 32, July 2013) (same).

discovered, this method would set California's true unfunded pension liabilities at more than $750 billion—triple the current recognized liability.[12]

In an important sense, California's pension authorities have already implicitly recognized that Rauh's formula for determining unfunded liability is correct. They demonstrate this concurrence by using that very formula to calculate the cash-out liability of California municipalities that wish to leave CalPERS.[13] Jeremy Bulow has developed a useful narrative explanation of the flaws in using a discount rate based on the state's (generous) projections of what it hopes to make on its investments rather than a riskless cash-out rate,[14] and particularly why CalPERS's use of the higher discount rate for its own liabilities while using the lower rate for departing municipalities is so disingenuous.

> The way to think of it is this: Employees lend part of their compensation to employers in return for the promise of a future payment. Let's say that the payment is $200 twenty years from now. What is the amount of the debt that the employer has incurred that should be taken into account as part of the employee's compensation if the benefit is highly likely to be paid, as with the debt of a highly rated insurance company or corporation? Under current market conditions economists, insurance companies, and the Pension Benefit Guaranty Corporation would say that something like $100 is appropriate, with the employer borrowing from the employee at 3–4 percent interest. CalPERS has said to state and local governments, "We will say instead that the loan is for $50 at 7.50 percent interest, so that you only have to report a $50 current cost. But if tomorrow you want to pay off your loan (by making a lump sum payment to CalPERS which will then be responsible for paying the benefit) we will calculate it the same way as an insurance company, and you will have to pay $100." Even though cities and the state use CalPERS accounting as reporting their annual pension costs the reality is that CalPERS' calculation is more akin to the minimum payment that a credit card company will charge. Just making your minimum payment does not mean you have really balanced your budget; it just kicks the can down the road.[15]

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[12] *See* Rauh, *supra* note 3; *Interactive Map of Pension Liability by State and City*, POLICYED.ORG, *available at* https://www.policyed.org/pension-pursuit/pension-liability-state/map (California) (last visited Jul. 16, 2018).
[13] *See, e.g.*, Steven Greenhut, C*alPERS Is Shocked—Just Shocked—to Find Cities Reeling Under Growing Pension Debt*, REASON (Nov. 24, 2017).
[14] CalPERS currently uses a termination (riskless) rate of 3.25 percent. Jeremy Bulow, *The "California Rule" and Public Pensions* 9 (Stanford Institute for Economic Policy Research, Working Paper No. 17-018, Sept. 2017).
[15] Bulow, *supra* note 14, at 4.

In support of using the higher rate, states have argued that they should be excluded from normal investment valuations because the debtor in the case of government-employee pensions is not a private entity but—ultimately—the state itself, which cannot enter bankruptcy even if it wished to[16] and which can always raise taxes to cover its obligations. This argument, though, is undermined to the very extent that states carry "structural" unfunded pension liabilities—that is, pension liabilities that are unfunded even if the assumed discount rate is applied to the funds reserved for pension payments by the state government. These unfunded liabilities are themselves the embodiment of the state's unwillingness or inability to pay for all of the pension promises that it has already made. In other words, *any* material, structural underfunding—especially under the generous assumptions that states have been allowing themselves—undermines the case for using those generous assumptions and suggests use of the Rauh formula, which then radically underscores the true unwillingness of the taxpayers to underwrite their politicians' generosity.[17]

The dangers of using the higher discount rate to determine current unfunded liabilities are demonstrated particularly starkly in California. By employing a 7 percent discount rate to determine overall liability and municipalities' mandatory contributions to CalPERS while dropping the discount rate to the risk-free rate, CalPERS is in effect extorting municipalities to continue to act with fiscal irresponsibility. If a municipality continues to make promises that it doubts it will be able to meet to employees who rely on its assertions, then it can get the higher rate and minimize its payments. If, though, it acts on a belief that it has made and is making promises it no longer thinks it can keep, then its current unfunded obligations are calculated

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[16] Shepard, *supra* note 10, at § III.B.

[17] Other arguments made in defense of the higher, risky discount rate are examined, and found wanting, by Bulow, *supra* note 14, at 17–20.

using the lower, risk-free rate, and this vastly larger bill is presented all at once.[18] And so municipalities are left with no choice but to continue on their present course.[19]

California can ill afford these funding problems. While once world renowned as the land of milk and honey, California now faces harder times. Despite massive spending on social welfare programs,[20] California now has the highest poverty rate in the United States.[21] Its citizens spend more than a third of their income to house themselves, the third-highest rate in the United States.[22] Energy prices are some of the highest in the country.[23] Taxes are already some of the highest in the country,[24] with income taxes already some of the most progressive in the country,[25] which is resulting in an accelerating exodus of the middle class.[26] The state's education system, once a national model, has fallen in state rankings to the embarrassing side of

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[18] *See, e.g.*, Bulow, *supra* note 14, at 10 ("CalPERS will take the same promise that an insurance company will say is worth $100 at 4 percent and call the amount of the loan $60 at 7 percent, but with a $40 prepayment penalty. This allows the public employer to account for the cost of incurring the new liability as only $60"—unless it wants to leave the system, at which point the prepayment penalty kicks in.).

[19] Two recent events suggest that CalPERS is fully aware of both the unsustainability and the duplicity of its, in effect, dual bookkeeping, and actively using its duplicity to protect its short-term ability to maintain its remaining reputation without officially joining the calls for cuts in present pension promises. *See, e.g.*, Greenhut, *supra* note 13 ("In one case, it decided to seek a legislative sponsor for a bill that would enable it to shift the blame to local agencies whenever such agencies decide to stop making their payments to the fund and retiree pensions are cut as a result. In the second case, at the urging of cities CalPERS decided to delay a vote on a more actuarially sound means of paying off pension debt—rather than risk a fifth rate hike to local governments, and risk a mutiny among hard-pressed local governments.").

[20] *See* Kerry Jackson, *California, Poverty Capital*, CITY J. (Winter 2018) ("California state and local governments spent nearly $958 billion from 1992 through 2015 on public welfare programs, including cash-assistance payments, vendor payments, and 'other public welfare,' according to the U.S. Census Bureau.").

[21] *See id.* (citing the Census Bureau's Supplemental Poverty Measure, "which accounts for the cost of housing, food, utilities, and clothing, and which includes noncash government assistance as a form of income.")

[22] *Id.*

[23] *Id.* ("Extensive environmental regulations aimed at reducing carbon-dioxide emissions make energy more expensive, also hurting the poor. On some estimates, California energy costs are as much as 50 percent higher than the national average.")

[24] *See Income Tax Rates by State*, 2018 TAX-RATES.ORG, *available at* http://www.tax-rates.org/taxtables/income-tax-by-state (last visited Jul. 16, 2018).

[25] *See id.*

[26] *See, e.g.*, Joel Kotkin & Wendell Cox, *Leaving California? After Slowing, Trend Intensifies*, SAN JOSE MERCURY NEWS (Apr. 24, 2017); Thomas C. Frohlich & Alexander Kent, *States Where the Middle Class Is Dying*, 24/7 WALL ST. (Jan. 22, 2015).

mediocre.[27] As Gavin Newsom, the state's lieutenant governor, gubernatorial candidate, and former mayor of San Francisco, has recently recognized, "California is both America's richest state, and its poorest. We need growth and inclusion—an economy that shares the energy and diversity of this state and works for every Californian."[28] Fixing the pension-funding crisis in a manner equitable to both government workers and taxpayers generally can help to ensure that goal.

The California Rule

This crisis has many contributing factors, including generous legislatures, governors, and administrators; aggressive government-employee unions; and underrepresentation of the interests of private-sector taxpayers in the pension negotiation process. In California, significant responsibility also lies with the state's courts. Over the years, those courts have generally been thought to have developed what has come to be called, rather aptly, the "California Rule" of pension benefits. This set of precedents has been interpreted to forbid the

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[27] *Education Rankings: Measuring How Well States Are Educating Their Students*, U.S. NEWS & WORLD REP'T, *available at* https://www.usnews.com/news/best-states/rankings/education (last visited Jul. 16, 2018) (26th overall, but 44th in K–12 provision); Sharon Noguchi, *In National Rankings, California Schools Not Exactly Ahead of the Class*, SAN JOSE MERCURY NEWS (Jan. 5, 2017) (41st out of 51 US jurisdictions). *See also* John Woolfolk, *Study: California Governments Pay More, Have Lower Staffing,* OROVILLE MERCURY REGISTER (Jan. 28, 2018) ("In K–12 education, the Golden State's top spending priority, the analysis showed California spending per resident on K–12 schools was about average among the states, but while teacher pay was among the highest, the state trailed others in teachers and support staff per student. . . . The National Center for Education Statistics tells a similar staffing story using more recent figures and also shows California's math, reading, writing and science scores are below average. In higher education, the Urban Institute ranked California among the biggest spenders per resident, but also showed the state had among the fewest professors and other staff per student, even though they were the highest paid."); David Crane, *California's Own Shutdown: Schools Are Open but Shelves Are Barren*, MEDIUM (Jan. 20, 2018) ("Public schools in Los Angeles, Oakland, San Francisco, San Diego, San Jose and other urban centers are providing just a fraction of full services, resulting in understaffed classrooms, underpaid teachers, and fewer arts, science, math, and other classroom offerings. One result is that the poor and minority students that make up a large share of those urban districts underperform poor and minority students in other states that spend much less per student.").

[28] Gavin Newsom (@GavinNewsom), TWITTER (Feb. 16, 2018), *available at* https://twitter.com/GavinNewsom/status/964554242252947462. Newsom's tweet includes an embedded video that calls for "portable benefits" for Californians but fails to call for a migration to defined-contribution, 401(k)-style pensions for work not yet performed by California's government employees that would provide the only portable sort of pension benefits available.

state to reduce any pension benefits offered to any workers employed at the time the benefits were offered, for any work performed by those employees at any time during their employment with the state or its municipalities, such as counties, cities, and school districts.[29] Put another way, the California Rule has been interpreted to stop government entities from lowering pension benefits for current workers—even for work that those employees have not yet performed and may not perform for years or even decades to come.

The California Rule in effect has created a one-way ratchet of pension-benefit increase. Every benefit grant made either in good times or by union-friendly politicians has become semipermanent so that when the good times have turned bad, or less union-friendly officials have replaced their more accommodating colleagues in office, no diminutions of the previous largesse could be enacted, whatever the financial need or public support for such adjustments.

This mechanism has helped to facilitate the current crisis. Virtually all parties except the government-employee unions themselves are united on this point.[30] A 2011 study by the state-authorized Little Hoover Commission rang the fire bell in the night.[31]

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[29] *See, e.g.*, Marin Association of Public Employees v. Marin County Employees' Retirement Association, 2 Cal. App. 5th 674, 693–94 (Aug. 17, 2016) (Plaintiffs' essential position is clearly set out in their opening brief: "Public 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." "A corollary of this approach is that public employees are also entitled to any increase in benefits conferred during their employment, beyond the pension benefit in place when they began. . . . Since they are performing work under the improved pension system, the terms of that system become an integral part of their compensation, and they immediately become vested in the improved benefit." "Because A.B. [Assembly Bill] 197 has resulted only in the exclusion of payments from pension benefits, with no new benefit to offset the decreased pensions, this infringes employees' vested rights.").

[30] The unions are united that the California Rule must remain in place as currently interpreted, and that the state cannot restrict any options for already-employed government workers, including spiking pensions by larding their last year(s) of service with abnormal compensation that gets rolled into the pension award (called "pension spiking") or purchasing "extra years" of notional service (called "airtime") so as to bump up the pension-award formula. *See, e.g.*, Adam Ashton, *California Should Be Able to Reduce Public Employees' Pension Benefits, Jerry Brown Argues*, SACRAMENTO BEE (Nov. 22, 2017) ("'You have to twist yourself up pretty good' to believe the air time and spiking changes will hold up in court despite the 'California rule,' said Terry Brennand, pension director for SEIU California. 'You're taking away a benefit that is part of my program without offering me anything. I get removing it for future employees, but going backwards was a political move.'"). *See also* Ed Mendel*, New Ruling Called "Existential Threat" to Pensions*, CALPENSIONS (Sept. 19, 2016).

[31] *Cf.* Thomas Jefferson to John Holmes, Letter (Monticello, Apr. 22, 1820).

> 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 layoff employees to meet pension obligations. . . . In this report, the Commission confronts the elephant in the room: The legal obstacles that limit the options of state and local pension plans to reduce future, as-yet-unearned pension benefits promised to current workers.[32]

The Commission's recommendations were sweeping and ecumenical, including transferring employees to (partial) defined-contribution pension plans for future work,[33] decreasing formulas for capping already-earned benefits,[34] putting absolute caps on defined benefits,[35] ending pension-contribution holidays and increasing employee contributions,[36] and reducing government-employee (and thereby increasing taxpayer) control of their own pensions.[37]

Very recently, the League of California Cities renewed the alarm. "Pension costs for California Cities are approaching unsustainable levels, and . . . cities need more tools and options to ensure they are able to retain and attract public sector employees and continue to deliver high

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[32] Daniel W. Hancock, Chairman, Little Hoover Commission, to Edmund G. Brown Jr., Governor of California, et al., Letter (Feb. 24, 2011), *in* LITTLE HOOVER COMMISSION, PUBLIC PENSIONS FOR RETIREMENT SECURITY (Feb. 2011) (letter appears as preface to report).

[33] *Id.* ("Public agencies must have the flexibility and authority to freeze accrued pension benefits for current workers, and make changes to pension formulas going forward to protect state and local public employees and the public good. The Commission further urges the Legislature to pursue structural changes that realign pension costs and expectations of employees, employers and taxpayers. A hybrid model, which combines a lower defined-benefit pension with an employer-matched defined-contribution plan, is a model that must be made available to public agencies.")

[34] *Id.* ("The state needs to collapse unsustainable pension formulas and create a lower defined-benefit formula to facilitate this approach.")

[35] *Id.* ("A cap also must be put in place on the maximum salary that can be used to determine pension payments, or on the maximum pension that an employee can earn. The cap should protect pensions for lower-wage earners, but it is not the government's burden to exclusively fund the retirement of public employees and executives earning high salaries. Earnings that exceed the threshold should be steered into a portable defined-contribution plan, with the ability of employers to match employees' contributions, to encourage workers to remain employed, and to serve a mobile and professional workforce.")

[36] *Id.* ("All parties must pay a fair share. Contribution holidays from employers should be allowed only in rare cases of fiscal emergency—not when pension assets appear inflated by temporary market surges. Employees must contribute equally to their pensions.")

[37] *Id.* ("More independent members should be added to retirement boards to add needed perspectives about the public's tolerance for risk when setting aggressive assumptions for investment returns. Voters, too, deserve a say in benefit increases that they ultimately have to pay.")

quality municipal services to residents."[38] The CalPERS chief actuary likewise pointed out the unsustainability of the present pension promises almost a decade ago.[39]

The parties recognizing the unsustainability of the current situation and the state's inability to meet its current pension promises as presently interpreted under the California Rule include Governor Brown and his administration. In recent public comments he indicated his belief that the current interpretation of the rule will not last much longer. "'There is more flexibility than there is currently assumed by those who discuss the California rule,' Brown said during a briefing on the budget in Sacramento. He said that in the next recession, the governor 'will have the option of considering pension cutbacks for the first time.'"[40] He has supported this "hunch" that the California Supreme Court would soon "modify" the rule[41] by replacing the state attorney general's office in representing the state in one of the three cases recently decided by California appellate courts, and now before the supreme court, that offer the court just that opportunity. His administration argued forcibly for modifying the rule.[42]

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[38] *League Survey Confirms Need for More Tools to Sustain Pension System and Local Services*, LEAGUE OF CALIFORNIA CITIES (Feb. 1, 2018).

[39] *See* Ed Mendel, *When Do CalPERS Rates Become 'Unsustainable'?*, CALPENSIONS (Feb. 12, 2018) ("'I don't want to sugarcoat anything,' [then CalPERS chief actuary Ron] Seeling said. 'We are facing decades without significant turnarounds in assets, decades of—what I, my personal words, nobody else's—unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan . . . unsustainable pension costs. We've got to find some other solutions.'").

[40] Romy Varghese, *California's Brown Raises Prospect of Pension Cuts in Downturn*, BLOOMBERG POLITICS (Jan. 10, 2018).

[41] *Id.*

[42] *See* further discussion in the following section. Brown seems to have a fairly clear-eyed understanding of the parlous state of pension funding in California. In the same press conference in which he made the comments noted above, he predicted that "'at the next downturn when things look pretty dire, [pensions] will be on the chopping block.'" Adam Ashton, *Pensions Will Be 'on the Chopping Block' in Next Recession, Jerry Brown Says*, SACRAMENTO BEE (Jan. 12, 2018). His legislative efforts to reform the state's pension promises reach back to 1982, at the end of his first service as governor. *See, e.g.*, Ed Mendel, *Pension Reform: Brown Picks Up Where He Left Off,* CALPENSIONS (Jul. 31, 2010) (The 1982 effort, to limit pension promises for new workers then, was unsuccessful.).

The Cases

Three appellate decisions addressing the question of the California Rule now await California Supreme Court review. Each of these three cases was catalyzed by county efforts to apply the Public Employees' Pension Reform Act of 2013 ("PEPRA").[43] The statute represented a tentative first step to trim back the growth rate of pension-funding obligations.[44] The questions raised by these cases for the California Supreme Court is what its California Rule precedent really has been, whether it cares to maintain or to revise that precedent, and how the lower courts and the legislature should now proceed as a practical matter.

Of the cases, *Marin Association of Public Employees v. Marin County Employees' Retirement Association*[45] (referred to below as *Marin*) was decided first, in August 2016. The supreme court delayed review of that decision, though, while a sister case, *Alameda County Deputy Sheriff's Association v. Alameda County Employees' Retirement Association*[46] (referred to below as *Alameda*), awaited decision.[47] That decision was issued on January 8, 2018. The cases are now headed together for supreme court review but have not yet been scheduled.

The third case, *California Fire Local 2881 v. California Public Employees' Retirement System*[48] (referred to below as *Cal Fire*), was issued between *Marin* and *Alameda*, at the end of 2016. Because it was not encumbered by a mate, it has already proceeded to the high court and has been fully briefed on the state's behalf by the Brown administration's legal affairs office

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[43] *See* Cal. Stat. § 7522 *et seq*.; Stats. 2012, ch. 296; *Marin*, 2 Cal. App. 5th 674, 679, 682–82 (2016); *Cal Fire*, 7 Cal. App. 5th 115, 120 (2016); *Alameda*, 19 Cal. App. 5th 61, 75 (2018).
[44] *See Marin*, 2 Cal. App. 5th at 681–82.
[45] 2 Cal. App. 5th 674 (Aug. 17, 2016).
[46] 19 Cal. App. 5th 61 (Jan. 8, 2018).
[47] *See* California Supreme Court Case S237460, *Marin Association of Public Employees v. Marin County Employees' Retirement Association (State of California)*, Appellate Courts Case Information, *available at* http://appellatecases.courtinfo.ca.gov/search/case/mainCaseScreen.cfm?dist=0&doc_id=2155980&doc_no=S237460&request_token=NiIwLSIkXkw9WzApSCMtXEtIQFQ0UDxTICMuVzxTMCAgCg%3D%3D (last accessed Feb. 18, 2018).
[48] 7 Cal. App. 5th 115 (Dec. 30, 2016).

rather than (as is usual) by the attorney general's office[49] or CalPERS counsel, which handled it in the courts below.[50] Because the *Cal Fire* decision relies in part on the opinion issues in *Marin*, however, while the *Alameda* decision responds to *Marin*, and because it is unclear in what order the supreme court will ultimately rule in these cases (though *Cal Fire* will likely be heard first[51]), consideration here will begin with *Marin* and follow the chronological order of the cases' issuance by the appellate courts.

In the first of these cases, Marin County, facing daunting pension-funding liability, implemented PEPRA after its 2012 passage in time for the county's new provisions to become effective as soon as PEPRA did, on January 1, 2013.[52] By January 18, the government-employees' union had challenged the statute and Marin County's implementation.[53]

The *Marin* court reviewed the bundle of precedent that has led to current understanding of the California Rule and concluded that the California Supreme Court really has not staked out the extreme position generally ascribed to it. It noted that the court had asserted that "public employment gives rise to certain obligations which are protected by the contract clause of the [US] Constitution, including the right to the payment of salary which has been earned,"[54] but

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[49] *See* Intervenor and Respondent State of California's Answer to Amici Curiae Briefs, *California Fire Local 2881 v. California Public Employees' Retirement System*, No. A142793, 2015WL 3894586 (Cal. App. 1 Dist.) (Jun. 15, 2015).
[50] *See* CalPERS's Notice of Intent to Reply on Brief Filed in the Court of Appeal, *California Fire Local 2881 v. California Public Employees' Retirement System*, S239958 (Jul.14, 2017).
[51] Briefing has already been completed in *Cal Fire. See* California Supreme Court Case S239958, *California Fire Local 2881 v. California Public Employees' Retirement System*, Appellate Courts Case Information, *available at* http://appellatecases.courtinfo.ca.gov/search/case/mainCaseScreen.cfm?dist=0&doc_id=2176751&doc_no=S239958&request_token=NiIwLSIkXkw9WyAtSCNdTEhJUEQ0UDxTICBOIz9RMCAgCg%3D%3D.
[52] *See Marin* at 682–86.
[53] *See id.*at 687.
[54] *Id.* at 694, *citing* Miller v. State of California, 18 Cal. 3d 808, 815 (1977).

then concluded that "'earned' in this context obviously means in exchange for work already performed."[55]

It went on to conclude that the California Supreme Court had determined that even with regard to this already-earned but not yet paid compensation—i.e., pension benefits accruing to work already performed—"pension rights are not immutable. For example, the government entity providing the pension may make reasonable modifications and changes in the pension system. This flexibility is necessary '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.'"[56] In fact, however vested pension rights might be, they remain subject to ex post alteration by the legislature: "before the pension becomes payable . . . the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension."[57]

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[55] *Id.* at 694. As the *Marin* court elaborated, "In accordance with this view, a pension is treated as a form of deferred salary that the employee earns prior to it being paid following retirement. In *Miller*'s classic formulation: 'It is true that an employee does not earn the right to a full pension until he has completed the prescribed period of service, but he has actually earned some pension rights as soon as he has performed substantial services for his employer. [Citations.] He is not fully compensated upon receiving his salary payments because, in addition, he has then earned certain pension benefits, the payment of which is to be made at a future date. While payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.'" *Id.* at 695 (internal footnote omitted).
[56] *Id.* at 695 (*quoting Miller*, 18 Cal. 3d at 815–16).
[57] *Id.* (*quoting Miller*, 18 Cal. 3d at 816). The *Marin* court expanded:

> What the Supreme Court stated in Kern deserves more than the excerpt quoted in Miller: "The 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. . . . Thus it appears . . . 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." *Id.* at 696 (*quoting* Kern v. City of Long Beach, 29 Cal. 2d 848, 854–55 (1947)) (internal footnotes omitted).

The *Marin* court considered, but ultimately rejected, the possibility that the California Supreme Court had effectively undermined these protections of the legislature's ability materially to revise the value of unpaid pension benefits by a statement in *Allen v. Board of Administration*[58] that "any modification of vested pension rights must be reasonable, must bear a material relation to the theory and successful operation of a pension system, and, when resulting in disadvantage to employees, must be accompanied by comparable new advantages."[59] It concluded, essentially, that this use of "must" was accidental for a variety of reasons,[60] including that the *Allen* case itself would have come out differently if that court had actually meant "must" instead of "should."[61]

According to the *Marin* court, then, while the legislature could not abolish government-employee pensions, it could—in PEPRA or otherwise—diminish pension benefits without a corresponding concomitant benefit increase as long as the diminution, and the remaining pension benefits, remain "reasonable."[62] It concluded that stopping government employees from "pension spiking"—from artificially inflating their total income in their last year(s) of service to inflate

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[58] 34 Cal. 3d 114 (1983).
[59] *Id.* at 120.
[60] *See Marin*, 2 Cal. App. 5th at 698–99 ("First . . . only the least authoritative of the three sources cited actually supports the word 'must,' while the two Supreme Court decisions employ 'should.' Second, barely a month later, the Supreme Court—speaking through the same justice—filed another decision, which used the 'should' formulation from the 1955 *Allen* decision as quoted in *Abbott* [*v. City of Los Angeles*, 50 Cal. 2d 438 (1958)]. Third, the 1983 *Allen* decision involved retirees . . . who historically receive a heightened degree of judicial protection. Fourth, and most significantly, the 'must' formulation has never been reiterated by the Supreme Court, which has instead uniformly employed the 'should' language from the 1955 *Allen* decision." (internal citations omitted)).
[61] *See id.* at 699 ("The issue in *Allen* was whether pension payments to retired legislators could be reduced pursuant to new statutory and constitutional language. The trial court had concluded that reduction would be contrary to the contract clauses of both state and federal Constitutions. The Supreme Court reversed, holding that the reduction was not constitutionally improper. There is nothing in the opinion linking the reduction to provision of some new compensating benefit. If the court intended 'must' to have a literal meaning, the retirees would have won. They lost." (internal citations omitted)).
[62] *See id.* at 702 ("Thus, short of actual abolition, a radical reduction of benefits, or a fiscally unjustifiable increase in employee contributions, the guiding principle is still the one identified by *Miller* in 1977: "'the governing body may make *reasonable* modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension.'" (*Quoting Miller*, 18 Cal. 3d 808, 816 (italics added [in *Marin*])).

their pension benefits by increasing the base amount to which the multiplier is applied[63]—could not constitute an unreasonable denial of substantial pension benefits and so could not violate either the US Contract Clause or California precedent.[64]

In the *Cal Fire* case the operative issue was not pension spiking but "airtime," the practice by government workers of "purchasing" years they did not work to include in their pension calculations.[65] The *Cal Fire* court, relevantly,[66] relied explicitly on the *Marin* court's analysis to conclude that the California Rule is not what it has been taken to be, and that California Supreme Court precedent did not bar PEPRA's withdrawal of the airtime option.[67]

In the *Cal Fire* case, the Brown administration took over the writing of the state's brief before the supreme court rather than leaving it to the California Department of Justice or to CalPERS counsel.[68] In that brief, Governor Brown put into legal action his concomitantly expressed "hunches" and expectations about the real contours of the California Rule and the course the California Supreme Court might be expected to take.[69] The administration's brief cited the Little Hoover Commission's warning of impending disaster and its call for reform (if

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[63] *See also infra* notes 65 (discussion of airtime), 103 (discussion of base pension multipliers).
[64] *See Marin*, 2 Cal. App. 5th at 704 ("We conclude" that Marin County's "implementation of [PEPRA] does not qualify as a substantial impairment of plaintiffs' contracts of employment with its right to a 'reasonable' and 'substantial' pension. Thus there is no violation of the state and federal Constitutions.").
[65] Here is a simple example of airtime: Assume a worker has 28 years of service. She wants to retire with a larger retirement benefit than 28 years of service would bring her. She thus "buys," say, two years of service with a payment to her employer, thus bringing her up to 30 years. The 30-year figure is then employed in the calculation described above to determine the employee's initial annual pension benefit. *See Cal Fire*, 7 Cal. App. 5th 115, 120 (2016).
[66] "Relevantly" because the court also found the airtime withdrawal to be constitutional on independent grounds that do not implicate the examination of the California Rule that the *Marin* court undertook and that is the burden of this paper's analysis. This independent ground is that the "airtime" option was meant to be revenue neutral, not a benefit designed to allow employees to amplify their overall total compensation, and that to the extent that it has become the latter, it represented an illegitimate and unauthorized pension benefit that could be stopped even under the broadest understanding of the California Rule without requiring the state or its instrumentalities to offer any compensatory increase in other benefits. *See Cal Fire*, 7 Cal. App. 5th at 120, 130–32.
[67] *See id.* at 131.
[68] *See supra* notes 49, 50.
[69] *See supra* page 14.

not endorsing any of the Commission's specific recommendations),[70] cited with approval a seminal article by Professor Amy Monahan critical of the standard interpretation of the California Rule,[71] and itself expressly rejected that standard interpretation. Rather, it contended that "the absence of comparative new advantages is not dispositive in every case involving the [reduction] of vested [pension] rights of current employees."[72] It then essentially endorsed (or tracked, anyway) the *Marin* court's arguments.

First, the Brown administration looked back to the guiding principles espoused by the United States Supreme Court in applying the federal Contract Clause.[73] Turning to California precedent, it asserted that "the absence of comparable new advantages has been [only] one of *multiple* factors to be considered in determining whether modifications are reasonable and justified. What *is* indispensable is that modifications of pension rights 'bear some material relation to the theory of a pension system and its successful operation.'"[74] Such considerations permit pension reductions "if the impairment is limited and does not meaningfully alter an employee's right to a 'substantial or reasonable pension'" of the sort that concerned the *Marin* court.[75] Under this understanding, "to evaluate necessity, courts look to whether a 'more moderate course' would have served the State's 'purposes equally well,' and whether the State

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[70] *See* Intervenor and Respondent State of California's Answer Brief on the Merits 17, *Cal Fire Local 2881 v. CalPERS*, Case No. S239958 (submitted Nov. 6, 2017) (hereinafter "Brown Administration Brief").
[71] *See id*. at 38 n.12 (*citing* Amy Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012)).
[72] *See* Brown Administration Brief at 36.
[73] *See id*. (The California Supreme Court's "precedent requires looking more broadly at the reasonableness and necessity of the impairment, not just at whether there are comparative new advantages. 'An impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.'" (*quoting* US Trust Co. of New York v. New Jersey, 431 U.S. 1, 25 (1977)).
[74] *Id.* at 38 (*quoting* International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d 292, 301 (1983); Allen v. City of Long Beach, 45 Cal. 2d 128, 131 (1955)).
[75] *Id.* at 39 (*quoting Miller,* 18 Cal. 3d at 816).

considered the impairment 'on par with other policy alternatives,'"[76] but they must pay "at least some deference to legislative policy decisions" to reduce pension benefits.[77]

The final case in this series is *Alameda*.[78] The *Alameda* court concluded that some portions of PEPRA had at least potentially made material reductions to government employees' pension benefits[79] and so reviewed the content and applicability of the California Rule.[80] It undertook this analysis in direct contemplation of—and, in effect, in doctrinal agreement with but practical divergence from—the *Marin* court's decision.[81]

The *Alameda* court accepted a core piece of the *Marin* court's analysis: it agreed that the California Rule, whatever else it means, should be read only to suggest that pension-benefit reductions *should*, rather than *must*, be counterbalanced by comparable benefit increases.[82] In short, it agreed with the *Marin* court that the California Rule is "in effect, 'a recommendation,

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[76] *Id.* at 45 (*quoting US Trust Co.,* 431 U.S. at 30–31).
[77] *Id.* (*quoting* Baltimore Teachers Union, Am. Fed'n of Teachers Local 340, AFL-CIO v. Mayor & City Council of Baltimore, 6 F.3d 1012, 1019 (4th Cir. 1993)).
[78] 19 Cal. App. 5th 61 (Jan. 8, 2018).
[79] *See id.* at 79 ("We believe that the trial court erred in refusing to determine whether legacy members have a vested right to be free from this uncertainty. In sum, since we conclude that subdivision (b)(1) represents a change to prior CERL law, it must be subjected to a vested rights analysis to determine whether legacy members have the right to have their pensions calculated without reference to its new prescriptions.").
[80] *See id.* at 79–101.
[81] *See id.* at 114 ("Recently, our colleagues in Division Two addressed this same issue with respect to legacy members of the Marin CERA [County Employees Retirement Association] and concluded that the amendment of section 31461 did not amount to an unconstitutional impairment of vested pension rights. As this issue is crucial to the resolution of our case, we will discuss the Marin holding in some detail. Preliminarily, however, we review precedent, specific to our high court, delineating the scope of a public employee's vested pension rights." (internal citations omitted)).
[82] *See id.* at 93–94 ("After tracing the origin of the 'must' language to a 1969 appellate court decision and establishing that it has never again been reiterated by the Supreme Court, Marin makes, we feel, a convincing argument that the use of 'must' in *Allen II* was not 'intended to herald a fundamental doctrinal shift.' Thus, according to Marin, the high court's vested rights jurisprudence generally requires only that detrimental pension modifications should (i.e., ought) to be accompanied by comparative new advantages. . . ." (internal citations omitted)). The press broadly treated *Alameda* as a victory for the government-employee union position, but the unions themselves understood it to be the sort of win King Pyrrhus would have recognized and rued. The union petitioned the Supreme Court for review of the *Alameda* decision, arguing that "the Court should grant review because the appellate court flatly refused to follow this Court's longstanding precedent requiring that any detrimental changes to pension rights 'must' be offset by new advantages." Petition for Review, *Alameda County Deputy Sheriff's Assn. et al. v. Alameda County Employees' Retirement Assn., et al.*, Case No. A141913 (submitted Feb. 2018).

not . . . a mandate.'"[83] It diverged with the *Marin* court, however, in its understanding of what this "should" means. "As the *Marin* court, itself, acknowledged, should does not mean 'don't have to.' It means 'really ought to.' Thus, when no comparative new advantages are given, the corresponding burden to justify any changes with respect to legacy members [i.e., government employees employed before the date of the pension benefit changes, whether those changes are prospective, retrospective, or mixed] will be substantive."[84]

This is where the practical distinction arises. The *Alameda* court admits that "total pension system collapse may be a sufficiently weighty concern to meet" its standard of substantive justification.[85] Nevertheless, when considering "the fiscal justification for application of the pension modifications at issue to legacy members, the court [must] specifically weigh[] the financial implications for [an individual municipal pension plan] if legacy members were exempted from those modifications, rather than impermissibly focusing on the unfunded pension liability crisis in general."[86] The *Alameda* court continued:

> In the end, we simply do not think that it is possible to engage in the individualized balancing test mandated by the Supreme Court's vested rights jurisprudence—and thereby determine whether it is reasonable to apply the pension modifications at issue to legacy members—without a specific analysis of the changes that have been effected by the new law; consideration of the impact of those changes on the legacy members at issue; and an evaluation of the legislative rationale for the change in the context of the facts of each specific CERL (County Employees Retirement Law of 1937) system. We therefore decline to follow *Marin*.[87]

Instead, the *Alameda* court remanded its case to the trial court for the individualized justification it considered necessary under its interpretation of the California Rule.

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[83] *Alameda,* 19 Cal. App. 5th at 94 (*quoting Marin,* 2 Cal. App. 5th 674, 699).
[84] *Id.*
[85] *Id.* at 97. The "may" in this sentence is startling. A standard that demonstrates that total system collapse awaits the failure of pension reduction, and yet says that may still not be enough evidence to justify the reduction, is a facially erroneous standard.
[86] *Id.*
[87] *Id.* at 97–98.

There is, obviously, a meaningful split between the lower-court opinions working their way to the California Supreme Court. The divergence is of practical significance, for if every unilateral pension reduction authorized by the legislature must be proved uniquely necessary to the continued functioning of the individual CalPERS "branch" when applying in any way to any "legacy" government employees, the process of reform may be stalled into meaninglessness. On the other hand, to the extent that pension reductions decrease already-earned or contracted-for compensation, something more than merely noting the existence of a generalized pension crisis really should be required.

The Decision: How the California Court Should Rule

These cases provide the California Supreme Court an excellent opportunity to disavow—or, if it prefers, to clarify—the California Rule. Both *Marin* and *Alameda*, in particular, include insights that can, despite the divergence in result between the two opinions, be synthesized in a coherent and satisfying way that will allow California to address its pension crisis in a manner expeditious, comprehensive, *and* respectful of the individual contract rights of each government employee.

A decision from the court that expressly retreats from the rule as currently understood, and that gives governments in California a free hand to reduce or otherwise materially change future benefits, will allow those governments to respond to the pension-funding crisis in equitable ways that comport with traditional rules about sovereign power, contract rights, and quasi-contractual doctrines such as reliance and performance.

To achieve all these ends, the court should distinguish between three categories of pension benefits: (1) benefits applying to work already performed; (2) benefits applying to work yet to be performed but explicitly promised to accrue to that future work by statute or contract;

and (3) benefits applying to work yet to be performed and not explicitly promised to apply in the future.

The government-employee unions have supported their maximalist position by asserting that the courts have only a toggle option available to them.[88] They can treat pensions as "mere gratuities," as they were treated everywhere early in the last century, that are subject to complete revision, reduction, or withdrawal at the sole discretion of legislative or executive whim.[89] Alternately, they can be treated as immutable facts extending forward through the employment of each government worker, never to be modified or reduced.[90]

This toggle-switch approach misses the opportunity to make important legal and policy distinctions, however. The most important distinction to be drawn is between benefits that have already accrued (i.e., benefits earned by work that has already been performed) and benefits that have not yet accrued because the work by which they will be earned has not yet been performed. When work has already been done, then the benefits promised for that work, whether pay or fringe benefits or the deferred compensation that is a pension benefit, ought to be paid except in extraordinary circumstances—such as fraud or other misdeed by the party owed or insolvency and inability to pay by the payor. (These already-accrued benefits will sometimes be referred to below as Type 1 benefits.)

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[88] *See Marin*, 2 Cal. App. 5th 674, 694 ("Plaintiffs candidly admit, 'In practice, this means that for existing employees, any changes must generally be neutral with regard to the overall benefit provided and cannot represent a net decrease in the pension benefit.' Less ambiguously, they assert 'neither Marin CERA nor the Legislature can now curtail those benefits.' Plaintiffs insist that if their position is not vindicated on this appeal, California will have returned to 'the view that public employee pensions are mere 'gratuities' to be granted or taken away at the whim of the employer.'" (internal footnote omitted)).

[89] *See id.*; Shepard, *Lead Lemming, supra* note 10, at § II.C.1 (citing Eddy v. Morgan, 75 N.E. 174 (Ill. 1905)); Dodge v. Bd. of Educ., 302 U.S. 74, 78–79 (1937); Andria L. Bentley, Comment, *The New York State Comptroller as Sole Trustee of the Common Retirement Fund: A Constitutional Guarantee?*, 72 ALBANY L. REV. 763, 767 (2009) (citing Roddy v. Valentine, 197 N.E. 260, 262 (N.Y. 1935) (reviewing the mutation of pension protections in New York from pure gratuities to something approaching quasi-contract, but recognizing that even as of 1935, such pension benefits could be stripped entirely away even after an employee's retirement); Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994–1003 (1977).

[90] *See Marin*, 2 Cal. App. 5th at 694.

These are basic principles of the law of contract, and they are supported by the equitable doctrines that in large part underlie contract law and inform the field of quasi-contract.[91] Contract law could not function if the paying party could slash payment after the contracted goods or services had already been provided or performed. The only sorts of transactions that could proceed would be those between parties who already trust one another so much that a contract would not be necessary. Meanwhile, the most basic rules of equity will not permit one party to change the terms of a deal after the other party has relied on those terms and has performed, and so cannot respond to the changing offer.

The fact that the contracting party paying these benefits is a government should not alter this analysis except in rare cases. While the legislative power must be free to make new rules by which the polity is to function in the future, and must be free in making these rules to react to changing economic circumstances and evolving political moods among the majority of voters, it need not as a matter of policy be free to reach backward in time to change already-fixed arrangements for already-completed work. In fact, it cannot be: if it were, it would be an unreliable contracting partner, which would either make government contracting impossible or at least raise the cost of that contracting exorbitantly.

This is not to say that there are no circumstances in which not-yet-paid benefits for work already performed might be adjusted. One justification for post hoc adjustment is practical: inability to pay. In the private-contract context, this inability to pay arises with insolvency and bankruptcy. If a private entity promises more payments than it can make, then some payees will

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[91] Consider, for example, the unilateral contract, wherein the promisor makes a promise that the promisee accepts by performing per the promisor's wishes. Performance creates in the promisor the obligation to pay per the promise. *See, e.g.*, *Contract*, BLACK'S LAW DICTIONARY 224–27 (abridged 6th ed. 1991). With regard to principles that inform quasi-contract, consider promissory estoppel, or "that which arises when there is a promise which promisor should reasonably expect to induce action or forbearance of a definite and substantial character on part of promise, and which does induce such action or forbearance, and such promise is binding if injustice can be avoided only by enforcement of promise." *Promissory Estoppel*, BLACK'S LAW DICTIONARY 843.

of necessity not get paid in full; in fact, bankruptcy law exists in part to try to ensure that all creditors of a bankrupt entity get paid the same fraction of what they are owed out of the assets remaining.

The details of this process differ in government contracts. States, for instance, are not even permitted to declare bankruptcy.[92] The details aside, though, circumstances can develop in which governments have made promises so extravagant, or where financial reality has changed so radically, that the governments cannot reasonably honor their promises—or, at least, cannot honor their promises without abandoning their fundamental responsibilities to the rest of their citizens. In these circumstances, the governments neither can nor should honor the insupportable promises in full, and both must and should be permitted by the courts to alter them.

Very different considerations obtain with regard to benefits that have not yet been earned, however. The key distinction, of course, is that no performance has occurred. Moreover, and crucially, while some reliance may have been placed, and some investments made, by contracting parties in the expectation that the benefits previously earned will continue into the future, that reliance and those investments can be justified, and need be respected at law or in equity, only if there is some sort of contractual justification for the reliance and the investments.

With regard to benefits that have not yet been accrued for work that has not yet been performed, then, the vital question is whether the state has explicitly contracted to continue the benefits into the future. This can occur in two ways: by employment contract or by a statute that includes language expressly committing to maintain a certain set of benefits through a certain fixed date. The former occurs fairly regularly, particularly in the form of collective-bargaining agreements with government-employee unions. The latter, though, is rare and plays no role in the

[92] *See, e.g.*, Shepard, *Lead Lemming*, *supra* note 10, at § III.B (citing David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L.R. 677, 679–80 and *passim* (2012)).

court's upcoming analysis. (This second category of benefits, those not yet earned but explicitly promised by contract or statute to continue into some future period, are sometimes called Type 2 benefits.)

When government employees have either express contracts or explicit contractual provisions that extend their benefits, then they are wholly justified in relying on those promises, and great weight should be given to the commitment to honor those promises. Because their contracting partner is a sovereign government, they cannot rely completely on the totality of the promises—in extremis, the legislative power will still allow some alteration of the contractual relation between government and employee in order to maintain the integrity of the government entity and at least minimal respect for the equitable relationship between the interests of government employees and interests of nonemployee taxpayers. Because, despite the contractual protections, the work has not yet been performed, the performance interest does not apply (or does not apply as strongly) to these benefits, and thus the judicial constraints against reducing the benefits are somewhat lower than in the case of retroactive reduction of already-earned benefits. In other words, it should be somewhat easier for the legislature to reduce this category of benefits, but not much—and only upon careful scrutiny by the legislature and evidentiary demonstration of serious need. (Any sort of evidence that the relevant contract had been inappropriately negotiated would, of course, to the extent of the demonstration, mitigate in favor of permitting reduction to this category of benefit.)

It is these Type 1 and Type 2 benefits to which the analysis by the lower courts in the cases considered above—particularly *Alameda*—and the Brown administration brief in *Cal Fire*[93] rightly applies. Here, "the . . . burden to justify any changes with regard to legacy

[93] *See* Brown Administration Brief, *supra* note 70, at 36–45.

members [should] be substantive."[94] For these types of benefits, "the court [must] specifically weigh[] the" unique characteristics of the proposed reductions, and either the justifications for them or the potential effect on the employees whose benefits are to be cut, or both, as appropriate.[95]

The final, third category of benefits (sometimes referred to below as Type 3 benefits), then, is comprised of those that are not covered by contract and that have not been extended to future work by explicit statutory provision. Nothing less than such an explicit commitment can restrain a legislature from altering any benefits it has conferred for work not yet performed. For if a legislature has not bound itself, then by the very nature of legislative power it maintains the right to alter its offer to current or future government employees just as it has the right to change the terms under which it will offer other future government contracts or to legislate generally. "The contract clauses do not foreclose government action which reflects changing concepts of public policy, concomitantly granting government the power to make illegal that which was previously legal."[96]

This right to reduce Type 3 benefits is essentially complete. It includes even the power to abolish, from the date of the legislation, all pension benefits for all Type 3 work and therefore includes all lesser changes or reductions, including a switch from defined-benefit

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[94] *Alameda*, 19 Cal. App. 5th 61, 94.
[95] *Id.*
[96] *Marin*, 2 Cal. App. 5th 674, 703.

pensions to defined-contribution pensions[97] for all Type 3 work or any changes within a defined-benefit system.

This legislative autonomy does no injustice to government employees. Those employees, like private employees, train for the work they wish to do (as by schooling or apprenticeship) without knowing whether they will be able to get jobs in their fields, much less how much they might be paid or what their benefits will be. They, like their private-sector counterparts, take the jobs offered to them because they are willing to exchange their work for the pay and benefit package offered to them. If that package is changed—if the pay or benefits offered for the coming year are reduced—then they are free to go out into the market to seek better wages and benefits, as and if they can.

If they *can't*—if no one will offer them the higher benefit package that the government employer is no longer offering—this is a fairly good indication that the government-benefit package had been too generous initially and ought to be reduced. The wage and benefits package that government employers should be offering is one that leaves government workers relatively indifferent between holding a government or a private-industry job. If government jobs are special, highly compensated plums in an industry, then the government compensation for those jobs is too high—higher than the market will properly bear.

Two problems arise if the government is compensating employees more than the market will bear. The first is that this is an obvious inequity to privately employed taxpayers. They are

[97] "'Defined-contribution' (DC) pensions are retirement benefit plans in which [regular] payments are made by management into personal accounts owned by employees. Once those payments are made, the employer has no further financial obligations. The eventual pension payouts will be a function of the market performance of whatever investments are chosen by individual employees. This stands in contrast to 'defined-benefit' (DB) programs. . . . Under DB programs, employees are promised various levels of retirement payments calculated through arcane formulas that leave management mostly uninformed as to the level of funding obligation to which they have agreed. In many cases, those liabilities turn out to be much larger than expected." Scott Shepard, *Following in TriMet's Tracks: Defined-Contribution Pensions a Necessary First Step to Oregon's Fiscal Health* (Cascade Pol'y Inst., Working Paper, Feb. 2018).

paying more tax than they should, or receiving fewer government benefits than they should, so that some lucky neighbors can make more than they would be able to make in non-taxpayer-funded positions. The second is that these overcompensated government jobs then become comfortable prizes that government officials, whether elected or appointed, can hand out to friends, relatives, contributors, or otherwise-connected "insiders." This is the very heart and touchstone of government corruption.

Finally, the California courts' long-standing misinterpretation of government workers' contract rights should not be used to itself justify the continuation of that interpretation. That is to say, workers should not be found to have developed cognizable reliance interests in the maintenance of current levels of pension benefits for Type 3 work simply because courts have in the past required that such levels be maintained. A rule of interpretation that stopped courts from correcting past doctrinal error *for future application* because interested parties expected that the error would never be corrected would effectively stop courts from correcting any doctrinal mistakes. The best way to respect worker reliance on the courts' previous interpretations is to respect Type 1 benefits (i.e., benefits that have already been earned) and not—under ordinary circumstances—to retroactively adjust those benefits downward on the basis of a current change in doctrine.

The California Rule, then, as currently understood, perpetrates an inequity on all taxpayers who are not themselves government workers by conflating Type 3 benefits with Types 1 and 2. Barring Type 3 benefits from reduction in the current conditions, when pension-funding payments are having such a significant effect on local governments' ability to provide basic services, endangers the residents of those localities.

The current ban against Type 3 benefit reductions is also inequitable to younger workers. Under the current interpretation, older workers hired in more flush—or foolish—times have locked-in benefits. To pay for these benefits, cuts are being made everywhere—including to the pay and benefits of newer employees. The result is that these newer employees, the ranks of whom are likely—particularly in California—to contain more women and minority-group members, make less in benefits than their older colleagues make and will never be able to catch up. This pay and benefit structure seems to violate particularly topical modern mores and basic considerations of fairness.[98]

For all of these reasons, the California Supreme Court should plainly declare that no statutory or contractual changes to Type 3 benefits create any constitutional problems or merit any judicial review of their content. In the language of the appellate court rulings, this declaration could take the form that *no* reductions, however significant, to Type 3 benefits constitute material changes to (accrued) employee pension benefits, properly understood. Alternatively, or additionally, the court might declare that no such changes can deprive any employee of a reasonable pension and therefore need not be balanced by any offsetting pension-benefit increases. Or it might abandon the language of the appellate courts and the accreted language of the California Rule and speak anew. (It is, after all, the court of final determination on questions of California law; it can speak anew, and it should do so, if clarity requires.) The

[98] Another way that the current reading of the California Rule hurts younger workers—and previously hurt workers who now have retired or are nearing retirement—is by tying government workers to their jobs (or, at least, to continuous government work in the state in which they start) and by deferring so much of their income into retirement. Chad Aldeman and Kelly Robson discovered in a recent study that "states' own assumptions show that on average, more than half of teachers do not receive any employer pension benefits because they leave before they are eligible. Just one in five stays on the job long enough to receive full benefits at retirement." Chad Aldeman & Kelly Robson, *Why Most Teachers Get a Bad Deal on Pensions*, EDUCATION NEXT (May 16, 2017).

key from a policy perspective is that it frees California's lawmakers to adjust Type 3 benefits as they see fit.[99]

The Aftermath

Significant positive results can be expected to follow a decision on the model suggested above. All of the state's subsidiary pension systems will initially be permitted and obliged to enact the provisions of PEPRA, which will bring some instant initial savings. Then, though, the legislature will be obliged to act again to give the pension systems throughout the state additional room to reduce their benefits.[100]

The legislature would be wise to craft this legislation carefully to take full advantage of the license offered by the California Supreme Court's ruling, while avoiding instant, colorable

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[99] There is an additional complication that could be thought to create a fourth type of pension reduction: a reduction that has some effect on already accrued benefits and some effect on benefits yet to be accrued. The *Marin* court asserts that the withdrawal of pension-spiking opportunities, because it applies only after a certain date and does not reach back to take away already-granted pensions based on spiked calculations, is purely prospective. *See Marin*, 2 Cal. App. 5th 674, 704–5. By one definition, this is literally and self-evidently true. By another, the question is less clear. Assume, for instance, that pension spiking had been explicitly blessed by California state law, rather than merely tolerated, prior to 2013. If this were true, then its curtailment in and after 2013 would at least arguably retract a benefit that had already been earned—the right to pension spike with regard to that portion of the pension already accrued in and before 2012.

Another example helps to clarify the problem. Imagine that in 2019 the California legislature reduced the multiplier for pension calculations back down to 2, from the 3 to which it was raised in 2001. *See infra* notes 103, 104. If the legislature limited the effect of this change to benefits accrued after the legislation passed, this would constitute only a Type 3 change. To the extent the reduction applied to benefits that had already been accrued, i.e., to work performed before the passage of the legislation, it would be a Type 1 change. This example presents few problems, however, and need not implicate a fourth category of analysis, because it is so easily divisible. The wholly prospective effects should be ratified by the courts without further analysis. The retrospective effects should be analyzed as a Type 1 change. Should the prospective move pass muster while the retrospective portion fails of it, the prospective portion should be maintained even while the retrospective is struck down, unless such a division has been forbidden expressly by the legislature, in respect for the forward-looking rulemaking authority that is central to the legislative power. *See, e.g.*, *Marin*, 2 Cal. App. 5th 674, 703. The practical application of this conclusion will be to apply a "blended" multiplier between 2 and 3 based on the number of years in which the employee accrued benefits under each legislative rule.

As the second example illustrates, there will be fewer real potential "Type 4" situations than might initially be expected. Where they arise, though, as arguably in the *Marin* pension-spiking analysis, then the best course is to analyze the whole reduction using the more careful Type 2 scrutiny, in respect for the fact that a plausible claim that some—but no plausible claim that all—of the reduction implicates benefits that have already been earned.

[100] *See, e.g.*, *Court Renders Ventura County Pension Reform Measure Dead on Arrival*, CALIFORNIA COUNTY NEWS (Aug. 11, 2014) (pension reform ballot measure in Ventura County canceled, despite getting requisite number of voter signatures to make the ballot, because withdrawal from CalPERS structure requires legislative approval).

objections by the unions to its efforts and yet building a record for further action should it be needed. Toward this end, the legislation should have four primary goals.

- First, it should forbid, statewide, some of the worst excesses that have marked the state pension system in recent decades.
- Second, it should empower subsidiary pension organizations, or voters by referendum at the state or municipal level, to make deeper cuts.
- Third, it should restrict the changes in these first two categories entirely to Type 3 reductions—the type that the California Supreme Court should render effectively unreviewable by the courts. This is necessary for two reasons: to make sure that the reductions will not be subject to long delay and possible defeat in the courts, and to provide a practical illustration as to whether these Type-3-only cuts are sufficient to save the system in an equitable manner.
- Fourth and finally, the legislation should require CalPERS to undertake a comprehensive study to determine the full extent of the state's unfunded pension liability assuming the baseline established by the legislation itself and under a variety of discount-rate scenarios. The legislation should mandate extremely detailed and comparative analysis and should include details such as how much funding would be spent to fully satisfy double-dip pensioners;[101] pensioners who already collect, or stand to collect, annual benefits in excess of certain threshold amounts;[102] and pensioners who already collect, or stand to collect, annual benefits higher than various multiples of some inflation-adjusted percentage of their final years' salary.

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[101] Cuts that look to trim pensions that exceed the Internal Revenue Service's standard public-pension limit—a limit that already exceeds $200,000 per year—should fall within this ambit. *See, e.g.*, Ed Mendel, *"Excess" Pension Payments Grow then Phase Out*, CALPENSIONS (Jan. 8, 2018).
[102] *See id.* Transparent California hosts information about individual government-employee pension benefits, *available at* https://transparentcalifornia.com.

This fourth step is not academic; it is critical. It is unclear whether the pension-funding crisis can be solved only by Type 3 benefit reductions. It is also unclear whether the pension-setting process that has dominated in recent decades bears the exterior hallmarks of good-faith, arm's-length bargaining in the interests of the general taxpayer rather than insider negotiations between parties dominated by those whose personal interests were to benefit from overgenerous pension promises. Either of these eventualities would be demonstrated by the sort of study recommended here, and either, if competently demonstrated, should allow for measured and equitable reductions of Type 1 and Type 2 benefits.

Another possible area of benefit reduction—one that might nominally, but functionally does not, qualify as either Type 1 or 2 benefits—would be of benefits that were themselves granted retroactively and so could not have arisen as a result of a contractual arrangement or created expectational or reliance interests in workers at any time, because they were never in any real sense "earned" but only granted—genuinely as a gratuity—after the work had been performed. An instance of such retroactive gratuities arises in the post-2000 decision to raise retroactively the pension-benefit multiplier[103] from 2 to 3.[104] As benefit increases such as these were no more than a boon of the legislature, they should be provided none of the protections that must otherwise be accorded to Type 1 or 2 benefits. On the other hand, though, equity should not

[103] Here is how the benefit multiplier works. An employee takes the number of years she has worked and multiplies that number by the multiplier. The resulting number is turned into a percentage. Then that percentage is multiplied by the employee's final-year salary, or an average of the salaries of the worker's last three years, or whatever the formula dictates. This final number is the retiree's initial annual pension benefit. An example: Assume a worker has worked for 30 years and that the multiplier is 3. These numbers, multiplied, make 90. When 90 is converted into a percentage, it makes 90 percent, or 0.90. Now assume that the employee made an average $100,000 salary over the employee's final three years. $100,000 × 0.90 = $90,000, which would be that employee's initial pension benefit.
[104] *See, e.g.*, Daniel Borenstein, *Appellate Court Issues Major Pension Reform Ruling*, SAN JOSE MERCURY NEWS (Apr. 20, 2017). As the calculation in the previous footnote suggests, this retroactive grant massively increased pension benefits—increased them by 50 percent, in fact, in the standard case—just at a time when the high-powered economy of the late 1990s was slowing considerably. It, and the contrived barrier to its swift repeal in the face of changed economic conditions that is the current California Rule, is significantly responsible for the funding crisis that exists today.

permit the courts to sweep away even retroactively granted gratuities upon which citizens, over a number of years, have come to reasonably rely and which they have no means of replacing. The legislature should limit itself accordingly in reducing or eliminating these gratuitous benefits, but it should be vigorous in withdrawing gratuitous pension benefits that do not fall within this narrow equitable exception.

Conclusion

The common understanding of the California Rule has always been an anomaly. Guaranteeing government employees that once they are hired, their pension benefits for the rest of their time with the state can only rise, regardless of political or fiscal conditions within the state, always set those employees apart from private-sector employees and from other government beneficiaries in ways not coherently justified in precedent. Now three California circuit courts and the current administration have all argued that the California Supreme Court has, in fact, never really asserted this incoherent rule—that it has all been a terrible misunderstanding. The California Supreme Court should embrace this opportunity and should disclaim the California Rule. It should then explicitly import into California precedent the commonsense distinction between benefits that have already been earned or contracted for, and thus are staunchly (though not inviolably) protected by the courts, and benefits that have not yet been earned or contracted for, and thus can merit no protection. The circuit courts have provided the supreme court the tools to do so. Should the court act now, California may begin to take material strides to defuse its pension-funding crisis and make its future pension payments equitable to taxpayers as well as to employees and retirees. It may not be the case that full flexibility with Type 3 benefits will be enough fully to defuse California's pension-funding crisis, but it would represent a useful start.