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Fitch: California Pension Ruling Highlights Reform Obstacles.

Fitch Ratings-New York-18 January 2018: A recent California judicial ruling underscores Fitch Ratings' view that reducing public pension liabilities will be politically challenging for most state and local governments and that some will depend on favorable judicial outcomes.

The January 8 ruling by California's First Appellate District of the Court of Appeal is one example. It affects a narrow class of plaintiffs in three counties and follows several previous legal challenges to state pension reforms adopted in 2012. The state Supreme Court has agreed to review the earlier cases but has not yet indicated a timeframe for such consideration.

The new ruling confirmed prior courts' conclusions that future pension benefits for existing public employees may be reduced, but the circumstances under which such changes are permissible are limited. The appellate court directed the trial court to consider the financial impacts of eliminating several provisions that allowed some public workers to boost retirement pay in its assessment of whether such modifications were reasonable. In addition, the appellate court rejected the argument that pension benefit reductions were warranted by the challenged financial circumstances of public pension plans and directed the trial court to assess how such plans would be specifically impaired by the continuation of the disputed benefits.

Much of the recent California pension litigation has centered on interpretation of the "California Rule," a state Supreme Court precedent from 1955 that established pension benefits, once granted, as a vested contractual right that cannot be subsequently impaired unless offset by a comparable new benefit. This principle has been cited as an impediment to pension benefit reductions in twelve states in addition to California. Some clarity on this point may be forthcoming from California's Supreme Court, but we expect that legal challenges will continue to slow governmental efforts to reduce pension liabilities.

Public pensions account for an increasing share of long-term governmental liabilities across the U.S. Fitch Ratings' median long-term liability burden for states in fiscal 2016 represents 6.0% of U.S. 2016 personal income, up from 5.6% in fiscal 2015. However, long-term liabilities vary widely across states, ranging from 1.4% of personal income for Nebraska to 28.5% for Illinois. Thus, potential credit pressures due to long-term liabilities vary significantly as well. We expect many efforts to reduce pension liabilities to depend on legal decisions going forward.

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