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Fitch Ratings: California Ruling Leaves Pension Status Quo Intact for Now

Fitch Ratings-New York-12 March 2019: California's Supreme Court ruling last week leaves the status quo intact on the legal protection of pension benefits in place in the state for decades, according to Fitch Ratings. However, as the first of several pending legal challenges to public pension reforms implemented at the state and local levels since the Great Recession, the court may yet provide further clarity on the extent of protections provided by the "California rule", a decades-long state judicial precedent holding that pension benefits – granted when employment begins – are constitutionally protected and cannot be impaired.

The decision, in Cal Fire Local 2881 v. California Public Employees Retirement System (Cal Fire case), upheld a signature reform provision of the state's Public Employee Pension and Retirement Act of 2013 (PEPRA), but otherwise left intact the aforementioned California rule. The impact of PEPRA is reflected in the pension liabilities that Fitch incorporates in its analysis, and thus the ruling has no impact on Fitch's rating of the state of California or local governments.

The 2013 reform provision at issue in the Cal Fire case eliminated the ability of existing employees to purchase additional service credit toward their own retirement, known as "airtime". The ruling, in Fitch's view, was significant insofar as it upheld a pension reform eliminating a benefit previously available to existing employees, but it was narrow in scope. The court essentially held that airtime was not intended by the state legislature to be irrevocable when it was authorized in 2003, nor was airtime a form of deferred compensation in the same manner as core pension benefits. Instead, airtime was viewed as an optional benefit similar to other fringe benefits available to employees.

However, by ruling that airtime is outside of core pension benefits, the court avoided, for the time being at least, ruling on the protection of accrued pension benefits under the California rule. This precedent, which dates back to the Allen v. City of Long Beach case of 1955, holds that reducing pension benefits, once vested, would constitute an impairment of contract. In California, the practical impact of this protection has been to lock in past legislative decisions to increase benefits, while preventing any effort to decrease benefits, except for new employees.

Roughly a dozen other states have modelled their own pension legal protections on the California rule, where it has generally constrained pension reforms that might materially reduce liabilities. In a few states, courts have narrowed which benefits are considered vested, for example by allowing lower accruals for benefits earned following a reform (such as in Oregon) or excluding some components of benefits, such as cost-of-living adjustments, from contractual protections (such as in Colorado).

It remains to be seen whether California's Supreme Court is willing to reconsider the extent of the California rule's pension protections more directly, although several pending cases may provide an opportunity. Two upcoming cases have to do with pension "spiking", the practice of inflating compensation just before retirement in order to boost future benefit payments; PEPRA narrowed which elements of compensation counted in this calculation in order to curb spiking.

The first case, Alameda County Deputy Sheriff's Association v. Alameda County Employees' Retirement Association (Alameda case), like the Cal Fire case, challenges another provision of PEPRA applicable to existing employees that exclude several elements of pensionable compensation from benefit calculations. The provision was overturned in a lower court ruling and has been appealed by the state to the Supreme Court. In a similar case, Marin Association of Public Employees v. Marin County Employees Retirement Association, the narrowing of pensionable compensation was upheld, but is expected to be ruled on by the Supreme Court after the Alameda case. The timing of both reviews is not yet known.

Fitch notes that former Governor Brown vigorously pursued a favorable outcome on the Cal Fire case, to the point of replacing the Attorney General in arguments before the Supreme Court with attorneys from the governor's office. Whether Governor Newsom will pursue the upcoming cases in the same manner is unclear at this point. That said, press reports during the last election campaign indicated that he supported maintaining the California rule even if it were weakened by courts.

In the event that the Supreme Court had overturned PEPRA's elimination of airtime, the impact could have been costly for employers. Airtime provisions were intended to be cost neutral, given that employees would have to purchase the incremental value of their higher benefits. However, in reality the cost of incremental benefits was based on the pension's actuarial and economic assumptions at the time of purchase, leaving employers responsible if these assumptions later proved inaccurate. The Cal Fire ruling noted CalPERS' assessment that the actual cost of airtime was underestimated by 12% to 38%, depending on the category of employee.

PEPRA covers the California Public Employees Retirement System, the California State Teachers Retirement System, and 20 county retirement systems established under the 1937 County Employee Retirement Law. PEPRA was signed by Governor Brown in 2012 and became effective Jan. 1, 2013, although many provisions of the law only became effective upon the expiration of collective bargaining agreements in place at the time. The state estimated at the time the law passed that it would lower its own cost of pensions by $55 billion over time, with billions more in savings for local governments. In addition to the provisions at issue in the California court cases, PEPRA lowered benefits for new workers, capped pensionable wages, restricted granting of retroactive benefit increases and prohibited pension contribution holidays.

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