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THE PUBLIC SECTOR

Game changer for pension reform: Court allows 'reasonable' changes in benefits

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In a ground-breaking decision issued in August, the California Court of Appeal shot down a constitutional challenge brought by employees and their unions against the Marin County Employees' Retirement Association's (MCERA) action to eliminate certain forms of "spiking"-type payments from being included in the calculation of employees' final compensation. "Spiking" is a practice whereby public employees use a variety of methods to inflate their income in order to increase their retirement benefits. Upon review, the court issued an extraordinarily strong opinion rejecting a challenge to MCERA's action and to the California Public Employees' Pension Reform Act (PEPRA) itself.

Management practitioners are applauding the court for its comprehensive and courageous analysis. On the other hand, union attorneys and plaintiffs' lawyers are characterizing the court's decision as a significant and erroneous reformulation of long-standing California rules governing vested rights in pension systems. If the decision isn't reversed by the California Supreme Court, it will facilitate further reform efforts by the California Legislature and local pension systems.

MCERA's compliance with PEPRA results in litigation

Hundreds of billions of dollars in unfunded liabilities have shined a nationwide spotlight on the generous retirement benefits that public employees receive from their pension systems. The California Legislature's response to this crisis—the enactment of PEPRA—affected the entitlements of employees covered by almost all California pension systems. In addition to reducing pension benefits for newly hired employees, PEPRA forbids pension systems from including a variety of spiking-related pay in the calculation of employees' "final compensation."

Struggling with its own pension difficulties, MCERA was one of the first pension boards to implement changes under PEPRA. In compliance with PEPRA, specifically, the recently amended Government Code Section 31461(b), MCERA adopted a new definition of "compensation earnable" that excluded standby pay, administrative response pay, callback pay, cash payments for waiving health insurance, and other pay from the calculation of members' final compensation earned after January 1, 2013. The changes would affect only employees who had not yet retired.

Court rejects challenge to pension spiking reform

Four labor organizations representing Marin County employees sued MCERA to stop the pension board from implementing the revised formula for calculating retirement income. The unions' main argument was that the pension offered to employees at the time of hire became a "vested right" protected by the Contract Clause of the U.S. Constitution and could not be reduced unless it was offset by a new benefit of comparable value. The state of California later intervened to defend the constitutionality of PEPRA.

The 1st Appellate District of the California Court of Appeal disagreed with the unions. The court held that the revised formula and the definition of "compensation earnable" were not unconstitutional impairments of the employees' vested pension rights because the changes were "reasonable." Most important, the court held that the changes imposed by MCERA did *not* have to be offset by a comparable new benefit as long as the changes were reasonable.

In reaching that conclusion, the court analyzed precedent from the California Supreme Court, most particularly language in *Allen v. Board of Administration,* a 1983 case in which the supreme court held that to be constitutional, a reduction in pension benefits *must* be offset by a comparable improvement. That language has been the cornerstone of historical efforts by labor unions opposing pension reform efforts. But after examining language in other decisions of the supreme court and the context in which *Allen* was decided, the court concluded that there was no strict requirement that pension benefit reductions always be accompanied by corresponding improvements.

The court emphasized that vesting rules enable pension changes as long as they do not substantially impair employees' vested right to a reasonable pension. This refined interpretation of vesting rules likely will raise the hackles of public-sector unions.

Additionally, the court observed that MCERA's elimination of spiking pay components was offset by a financial benefit—increased take-home pay. According to the court, because pension contributions were no longer taken from those pay components, employees received the full value of them in their paychecks. Despite that observation, however, the court did not clarify the parameters of what constitutes a "reasonable" change in pension benefits. *Marin Association of Public Employees, et al. v. Marin County Employees' Retirement Association, et al.* (California Court of Appeal, 1st Appellate District, 8/17/16.)

Bottom line

The *Marin County* decision is a game changer. Significantly, the 1st District apparently has dispensed with the long-held belief that any changes to overall pension benefits cannot result in a net decrease. Rather, a reduction in pension benefits is permissible as long as it is reasonable. In addition, the court has taken a much more expansive view of what constitutes "reasonable" changes to vested rights, focusing more on the public need to preserve the overall benefits.

The remaining question is how the California Supreme Court will respond if the unions appeal the 1st District's decision. While California law continues to provide great protection for public employee pension benefits, the 1st District's interpretation of PEPRA—if sustained—will give pension reform advocates momentum to continue their efforts to modify future pension benefits.

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