Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 27

MEETING DATE: August 19, 2020

SUBJECT: Update on New California Supreme Court Decision Upholding PEPRA

SUBMITTED FOR: __ Consent ___ Deliberation and Action __X__ Receive and File

RECOMMENDATION

Staff recommends the Board discuss the potential impact on SCERS policies and practices from the California Supreme Court opinion in *Alameda County Deputy Sheriffs' Association et al. v. Alameda County Employees' Retirement Association and Board of Retirement of ACERA* (also known as "the *Alameda* case"). This is a discussion item; no action is recommended.

PURPOSE

This item supports the Strategic Management Plan to maintain transparent communication among stakeholders, and promote understanding of roles and responsibilities regarding Board policies by which SCERS administers the retirement plan.

BACKGROUND

The California Supreme Court issued an opinion on Thursday, July 30, 2020 in the *Alameda* case, which involves several pay items for legacy members of county retirement systems that operate under the County Employees' Retirement Law of 1937 (CERL), including SCERS.

Some of the pay items at issue are similar to pay items under SCERS' Final Compensation Review Policy. Legacy members generally are those who have entry dates into SCERS membership prior to January 1, 2013, which was the effective date of the California Public Employees' Pension Reform Act (PEPRA). This lawsuit relates only to legacy members who retired on or after January 1, 2013.

In the *Alameda* decision, the California Supreme Court affirmed the constitutionality of Government Code section 31461(b) as applied to legacy members. Accordingly, SCERS will be reviewing its Final Compensation Review Policy to ensure that pay items are treated in conformity with that statute.

DISCUSSION

This agenda item should be considered an education session to:

- Provide an overview of the *Alameda* of the case and the Board's fiduciary obligations regarding compliance with the ruling,
- Identify pay items that SCERS currently includes in Final Compensation that might conflict with the *Alameda* opinion, and
- Discuss future decision points before the Board regarding changes to policies, potential adjustments to Final Compensation calculations prospectively and retroactively (i.e., to January 1, 2013, when PEPRA was enacted), potential contribution refunds, and notification to members and retirees.

An additional public comment period will be provided to accommodate stakeholder input.

NEXT STEPS

The Board will continue evaluating the Supreme Court opinion and develop a strategy to implement potential policy changes to comply with the *Alameda* ruling. Any policy changes will be presented at a public meeting at a future date. SCERS participating employers should continue to report to SCERS pay items as specified in the Final Compensation policy until further notice.

ATTACHMENT

- Nossaman LLP eAlert, July 31, 2020, "The California Supreme Court Addresses the California Rule and Public Retirement System Governance."
- Presentation of *Alameda* case by Ashley Dunning of Nossaman LLP.

Prepared by:

/S/

Stephen Lau
General Counsel

Reviewed by:

/S/

Eric Stern
Chief Executive Officer

The California Supreme Court Addresses the California Rule and Public Retirement System Governance

In a landmark decision of a unanimous court, on July 30, 2020, the California Supreme Court issued its second case in two years on the scope of the "California Rule," *Alameda County Deputy Sheriff's Assoc. et al., v. Alameda County Employees' Retirement Assn., et al.* (2020) __ P.3d.__ (WL 4360051) (S247095) ("*Alameda*"). In sum, the Court decided the narrow issue presented to it, determining that statutory amendments it considered were constitutional, while preserving the strength of the California Rule as to other legislative attempts to change pension benefits of current retirement system members to the member's detriment without providing comparable new advantages. As we discuss below, the Court's decision affirms the continuing force of the Rule in California, but refocuses judicial review of public pension changes in this State. For those alterations that disadvantage pensioners, courts will now closely examine the stated purposes of such modifications to determine whether they are justified and thus are permissible under the Contracts Clause of the California Constitution.

In *Alameda,* the Court first noted that just recently, in March 2019, the California Supreme Court issued its first decision in the five cases before it that challenged the constitutionality of various parts of the state legislature's Public Employees' Pension Reform Act of 2013 ("PEPRA") and related changes to statutes governing the State and county public retirement systems as provided in Assembly Bills 340 and 197 (2012) (collectively, "PEPRA"). In that case, *Cal Fire Local 2881 v. California Public Employees' Retirement System* (2019) 6 Cal.5th 965 ("*CalFire*"), the Court

provided a comprehensive analysis of the predicates necessary to determine whether a particular employment or pension benefit is a "vested" contract right, and thus constitutionally protected, under California law. The *CalFIRE* Court unanimously concluded that "California's public employees have never had a contractual right to the continued availability of the opportunity to purchase [Additional Retirement Service, or "ARS"] credit." (*CalFIRE, supra,* 6 Cal.5th at p. 993.) Accordingly, the Court stated that its decision "expresses no opinion on the various issues raised by the state and amici curiae relating to the scope of the California Rule."

In *Alameda*, the Court turned to the issue left on the table in *CalFIRE* – the meaning of the California Rule – and applied the Rule to PEPRA provisions amending the County Employees Retirement Law of 1937 ("CERL; Gov. Code, §31450 et seq.). The PEPRA provision at issue "amended CERL's definition of compensation earnable to exclude or limit the inclusion of additional types of compensation in an effort to prevent perceived abuses of the pension system." The Court noted that the challenge to PEPRA's amendment of CERL raised two sets of issues.

Settlement Agreement, Board Resolutions, and Related Issues

The first set of issues concerned settlement agreements or other promises made by CERL boards: namely, do these actions provide a contractual or equitable right to members of those retirement systems to continue to receive the benefit of those promises, even when the benefits were no longer permitted because of PEPRA's statutory changes? The Court concluded that they do not. "[N]either argument authorizes the county retirement boards to administer CERL in a manner inconsistent with the governing statutory provisions by including items of compensation in compensation earnable that section 31461, as amended, excludes." The Court explained the role of the board of public retirement systems as managing the retirement's "financial assets," and "processing and payment of claims for benefits under the plan." "Of necessity," the Court observed,

"the task of processing claims for retirement benefits requires the county retirement boards to interpret and apply the provisions of CERL, including the sections defining compensation, compensation earnable, and final compensation." But the Court drew a line on benefit *changes*: "The task of a county retirement board is not to design the county's pension plan but to implement the design enacted by the Legislature through CERL."

With respect to settlement agreements that promised benefits in excess of that which PEPRA permitted, the Court concluded "any provision in the settlement agreements that would have required the retirement boards to continue to apply the agreed upon characterizations in the face of contrary legislative changes or authoritative judicial interpretations would have been void. The retirement boards had no authority to enter into an agreement that would require them to pursue a policy that conflicts with the governing legislation." Thus, the Supreme Court concluded that settlement agreement terms could not properly be invoked as a rationale not to implement PEPRA.

With respect to a more general invocation of the doctrine of equitable estoppel resulting from Board resolutions as well as the agreements, the Court rejected the Court of Appeal's conclusion that it applied and held, "because we find no actionable representations in the settlement agreements that would support invocation of that doctrine. Equitable estoppel generally must be premised on some type of representation, ordinarily false, about a set of circumstances." The Court thus found "no basis for estopping the county boards from adjusting their policies in response to the PEPRA amendment, as they are required by law to do."

Constitutionality Issues

The second set of issues the Court addressed was whether PEPRA's amendment to CERL's definition of compensation earnable violated the rights of county employees under the Contract Clause of the California Constitution. The California Rule, which provides Contracts Clause-based protection of a public employee's right to continue accruing retirement

benefits on the same or better terms during their future public employment as they did during their prior years of qualifying public employment, has been the subject of extensive academic and political discussion. The Rule, also adopted in a number of other states, is premised on the view that retirement benefits provided through legislation or similar governmental action are a form of deferred compensation promised by the employer and thus are a part of the employment contract of the employee. The Court discussed the more than half-century of its judicial history at length and, in the main, affirmed it, observing that from its first substantive articulation of the rule in *Allen v. City of Long Beach* (1955) 45 Cal.2d 128 (*Allen I*), through "the intervening 65 years, our decisions have clarified aspects of the *Allen I* test, but its substance is unchanged." The Court synthesized these decisions into a two-part test. A court must "first … determine whether the modifications impose an economic disadvantage on affected employees and, if so, whether those disadvantages are offset in some manner by comparable new advantages." If the modifications result in disadvantages, "[t]he court must then determine whether the government's articulated purpose was sufficient, for constitutional purposes, to justify any impairment of pension rights."

This summation of the California Rule is clearly consistent with prior California Rule caselaw. On one hotly-contested point, however, the Court sided with two lower courts of appeals in holding that when a change in law results in disadvantages to employees, it "should," and not "must," be accompanied by "comparable new advantages." On its face, this is arguably a change to the strictures of the Rule. But the Court appeared to limit its application through its review of prior caselaw and the types of "permissible purposes" that will justify a disadvantageous change in pension rights.

Returning to the legislation at issue, the Court described the nuances of the CERL's definition of compensation earnable, observing that it "is both very general and somewhat inscrutable." It also examined the Court's own first decision interpreting that statute in *Ventura County Deputy Sheriffs' Assn.*

v. Board of Retirement (1997) 16 Cal.4th 483, 499 (*Ventura County*) and concluded that because PEPRA excluded certain pay items from compensation earnable that *Ventura County*, in a "brief but relatively summary" manner "appears to include," PEPRA's amendment of section 31461 "constituted a modification of CERL," as to all but "termination pay." Because the legislative changes to the CERL definition of compensation earnable resulted in smaller pensions than *Ventura*'s interpretation of the pre-PEPRA version of the statute would have required, and did not provide a "comparable new advantage," the Court held that these changes were sufficient to meet the "first component" of the California Rule.

The Court then turned to the second component of the Rule: in order to be constitutional, changes to a public pension must have been enacted for a constitutionally permissible purpose and must be sufficiently limited as discussed below. Observing that "public employee pension plans may be modified 'for the purpose of keeping [the] pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system,'" to survive contract clause scrutiny such changes 'must bear some material relation to the theory of a pensionsystem and its successful operation.'" (*Quoting, Allen I*, *supra*, 45 Cal.2d at p. 131.) The Court then concluded, "assuming the changes were made for a proper purpose, one further analytic step is necessary ...: The Legislature's decision to impose financial disadvantages on public employees without providing comparable advantages will be upheld under the contract clause only if providing comparable advantages would undermine, or would otherwise be inconsistent with, the modification's constitutionally permissible purpose." Here, the Court "conclude[d] that the PEPRA amendment survives this constitutional scrutiny."

Significantly, the Court concluded "PEPRA's amendments of CERL were enacted for the constitutionally permissible purpose of conforming pension benefits more closely to the theory underlying section 31461 by closing loopholes and proscribing potentially abusive practices." The Court further

explained: “the amendment was designed to limit pension spiking, the manipulation of compensation to artificially increase a pension benefit. Unquestionably, preventing manipulation of the terms of a pension plan to produce outsize benefits is a substantively proper reason for modifying the plan, since it serves to maintain the system’s financial integrity and discourage gamesmanship in the management of compensation practices.” Relying on its prior decisions, the Court was also quick to “delineat[e] what is *not* a constitutionally permissible purpose.” The Court stated that these non-permissible purposes include “essentially political reasons,” such as responding to “the objections of taxpayers,” and “an attempt to stem rising pensions costs[.]”

The Court then ventured into new territory: “In featuring a properly motivated pension modification that imposes uncompensated financial disadvantages on plan participants, this matter requires us to address for the first time the interplay of the two parts of the *Allen I* test.” It noted, “There is no doubt that *Allen I* requires a modification of public employee pension rights to have been properly motivated — that is, to have been enacted ‘for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system’ and to ‘bear some material relation to the theory of a pension system and its successful operation.’” (*Allen I*, *supra*, 45 Cal.2d at p. 131.) Less clear is the role of the second part of the test, the offsetting of financial disadvantages with comparable new advantages.

The Court resolved the second part of the test as follows: “the contract clause requires a properly motivated pension modification to provide comparable new advantages to offset any financial disadvantages unless to do so would undermine, or would otherwise be inconsistent with, the constitutionally permissible purpose underlying the modification.” The Court further held that “the PEPRA amendment at issue here is constitutional under this analysis.”

The Court recognized the arguments of the State and various amici that the California Rule "constitutes an improper interpretation of the contract clause and bad public policy." In its conclusion, the Court responded to these attacks: "[W]e have no jurisprudential reason to undertake a fundamental reexamination of the [California] [R]ule. The test announced in *Allen I*, as explained and applied here, remains the law California."

The Court also addressed two other important issues of public retirement system governance about which we have previously written (see https://noss.law/CaliforniaRule): (1) Retirement system correction of errors; and (2) Retirement Board attempts to improve system operations. We believe *Alameda* definitively upholds both important governance rules for retirement boards, confirming that retirement boards have the authority to correct retirement system errors, and to improve retirement system operations, and not be bound by estoppel principles into perpetuating the erroneous construction of statutes.

As we stated in our prior article, and the California Supreme Court has affirmed in *Alameda*, the California Constitution expressly affords public retirement boards "plenary authority, consistent with their fiduciary responsibilities," to administer the retirement systems they govern. The express grant of authority and discretion means that they may, and must, correct errors and improve operations within the retirement system, after a careful balancing of short and long-term interests of their members and beneficiaries. The Supreme Court's guidance on this topic provides critical confirmation of that aspect of public retirement system governance, while also confirming the significance of the California Rule to the administration of public retirements, in California.

NOSSAMAN LLP

Fiduciary Counsel Comments on SCERS's Implementation of Alameda Decision

Presented by: Ashley K. Dunning, Partner

Co-Chair, Public Pensions & Investments Practice Group

Presented to the Board of Retirement of Sacramento County Employees' Retirement System

August 19, 2020

California Law – The State Constitution and the *Alameda Decision*

- Article XVI, Section 17 vests the Board with "plenary" authority over the administration of SCERS, subject to its fiduciary duties.

- On July 30, 2020, the California Supreme Court filed its decision *Alameda County Deputy Sheriff's Assoc. et al., v. Alameda County Employees' Retirement Assn., et al.* (2020) __ P.3d.__ (WL 4360051) (S247095) ("*Alameda*").

- Now that *Alameda* has been decided by the highest court in California, and it interprets the law applicable to county retirement systems, SCERS is bound by its mandates.

- In *Alameda,* the Court described the fiduciary and administrative role of public retirement boards to implement statutes governing them as those statutes are written.

California Law-
The County Employees Retirement Law of 1937 ("CERL")

- Government Code section 31461 of CERL, as amended by Assembly Bill 197 (2012-2013) and the Public Employees' Pension Reform Act of 2013 ("PEPRA"), required new exclusions from "compensation earnable" that the *Alameda* Court determined were, in large part, changes in the law.

- The *Alameda* Court further determined that the new exclusions were both constitutional (thus, not a violation of legacy members' vested rights) and must be applied, even if pre-existing settlement agreements or other Board actions provided that such pay items would be included in compensation earnable, and even if active members had paid retirement contributions on those pay items.

Prior SCERS Board Actions on Compensation Earnable

- The Board continued to include a number of pay codes of its legacy members that were potentially required to be excluded by PEPRA, deferring further action on those pay codes until *Alameda* was decided for potential vested rights and estoppel-based considerations.

The *Alameda* Decision

- *Alameda* was filed on July 30, 2020 and, pursuant to applicable California Supreme Court rules, is to be final thirty days later.

- *Alameda* rejected vested rights and estoppel-based concerns that dissuaded the SCERS Board from acting on PEPRA with respect to legacy members previously.

The *Alameda* Decision

- Significantly, the *Alameda* Court's conclusions were based on its analysis of the narrow questions relating to the legality of PEPRA amendments to the compensation earnable statute.

- Because those amendments were consistent with the "theory and successful operation" of a public pension system, and because requiring a "comparable new advantage" to members who were disadvantaged by the change in law would undermine the constitutionally permitted purpose of the change, the changes were upheld as a matter of both law and equity.

SCERS Implementation of *Alameda*

- Four key questions arise:
  - To whom does *Alameda* apply?
  - As to what period of time are benefits to be corrected?
  - What about member contributions?
  - What pay items must be excluded?

Question No. 1: To Whom Does *Alameda* Apply?

- The *Alameda* Court stated:

  "County retirement boards . . . have the ordinary authority of an administrative body to resolve, in the first instance, ambiguities in the interpretation and application of these statutes, but nothing in the text of sections 31460 and 31461 hints that the discretion extends further."

  (Emphasis added.)

Question No. 1: To Whom Does *Alameda* Apply? (cont.)

- The *Alameda* Court also stated:

  "We assume for purposes of this analysis that the settlement agreements embodied permissible interpretations of CERL at the time they were executed. The issue here is whether the retirement boards could have agreed to *continue* to implement those interpretations despite a statutory amendment that rendered the interpretations contrary to CERL. For the reasons discussed above, such a provision would have been beyond their authority. County employees can have no express contractual right to the continued adherence to interpretations of CERL that are now, as a result of PEPRA, contrary to the statute." (Emphasis added.)

Question No. 1: To Whom Does *Alameda* Apply? (cont.)

- *Alameda* thus determines that PEPRA's amendments to section 31461 apply effective January 1, 2013, as written.

- There is no basis to perpetuate the erroneous construction of CERL as the Supreme Court concluded in *Alameda*, even as to currently retired members. *See generally, Retirement Cases* (2003) 110 Cal.App.4th 426 ("Retirement Cases"); *City of San Diego v. San Diego City Employees' Retirement System* (2010) 186 Cal.App.4th 69 ("City v. "SDCERS").

Question No. 1: To Whom Does *Alameda* Apply? (cont.)

- Thus, as to SCERS, *Alameda*'s interpretation of PEPRA amendments to section 31461 (the "PEPRA Exclusions") applies to SCERS legacy members who retired, and will retire, on and after January 1, 2013, because that was the statute-based law applicable to those individuals when they retired.

Question No. 2: As to What Period of Time Are Retirement Benefits to Be Corrected Under *Alameda*?

- Retirement benefits that SCERS pays retirees going forward are to implement PEPRA's amendments to section 31461.
- A decision will need to be made about any potential recoupment of overpayments from retirees with respect to the new exclusions.
- Tax counsel to address federal tax qualification topic regarding permissible error correction.

Question No. 3:
What About Member Contributions?

- As stated in *Alameda* footnote no. 18, it did not "address," or thus decide, whether the return of any member contributions made on pay items that are excluded by section 31461, as amended, are warranted.

- As to member contributions taken on pay codes associated with the PEPRA Exclusions before January 1, 2013, contributions were not only permitted, they were required by CERL. The PEPRA amendments to CERL do not provide for a refund of such contributions. *Cf.* Gov. Code sec. 7522.74 (felony forfeiture statute provides for certain refunds of contributions).

Question No. 3:
What About Member Contributions? (cont.)

- A decision will need to be made about whether and how to return contributions to active and deferred members that were taken on excluded pay items from January 1, 2013 forward, including addressing the topic as to retired members where the overpaid benefits offset the members contributions that were paid on excluded items.

Question No. 4: What Pay Items Must Be Excluded from Compensation Earnable Now?

- *Alameda* described somewhat greater restraints on CERL Boards than previously was understood with respect to inclusions in compensation earnable that statutes did not permit (e.g., the *"Guelfi* footnote 6" issue and *Alameda* Exclusions).

- Per the Supreme Court's discussion of section 31461, as amended, PEPRA also closes certain "loopholes" such as straddling of fiscal years for leave cashouts (a PEPRA Exclusion) and inclusion of "in-kind" benefits in compensation earnable (an *Alameda* Exclusion).

Question No. 4: What Pay Items Must Be Excluded from Compensation Earnable Now?

- Mandatory exclusions are in subdivisions (b)(2), (3) and (4),
- Exclusions in subdivision (b)(1)(A), (B) and (C) are more discretionary in that the Board "may" exclude such items, such as conversions to cash of in-kind benefits, one-time or ad hoc payment of benefits, and pre-termination golden handshakes.
- Discretionary, as opposed to mandatory, PEPRA Exclusions should not be applied for the first time to current retirees now as a result of *Alameda,* unless a board took such action in response to PEPRA previously and applied that action to future retirees.

Question No. 4: What Pay Items Must Be Excluded from Compensation Earnable Now? (cont.)

- SCERS is to determine each pay code that is not to be included in compensation earnable under the PEPRA amendments and exclude those pay codes for purposes of both contribution collection and benefit payments for individuals who retired from SCERS on or after January 1, 2013.

- Subject to further review, those pay items appear to include:
  - Standby Pay
  - Vacation Cash-In that exceeds the amount "earned and payable in each 12-month period during the final average salary period"
  - Animal Allowance (both legacy and PEPRA members)

- The Board should adopt a Resolution Implementing the *Alameda* Decision, providing proper direction to SCERS staff on these topics.

Questions?

Thank you