In the Supreme Court of the State of California

Cal Fire Local 2881, et al., **Petitioners and Appellants,** **v.** **California Public Employees' Retirement System (CalPERS),** **Defendant and Respondent,** **and** **The State of California,** **Intervener and Respondent.**	Case No. S239958

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Alameda County Superior Court, Case No. RG12661622
The Honorable Evelio Martin Grillo, Presiding Judge

INTERVENER AND RESPONDENT STATE OF CALIFORNIA'S ANSWER BRIEF ON THE MERITS

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INTRODUCTION

Twenty years ago, federal tax law began allowing state and local public pensions systems to sell additional, fictional years of retirement service credit to their members. When purchased and added to an employee's years of actual service, this "airtime" artificially increased the number of years used to calculate the employee's pension.

In 2003, the California Legislature enacted legislation granting many public employees in the state the option to purchase airtime. The legislation was premised on the assumption that it would cost public employers nothing—employees electing to participate were supposed to pay both their share *and* their employers' share of the full present cost of future pension benefit increases. Over the program's first several years, however, serious flaws emerged. Allowing employees to inflate their pensions with airtime undermined the principle that public pensions rewarded faithful public service and fueled cynicism about public employee pensions. To compound matters, many public employees used the program to retire earlier than they otherwise would have, exacerbating already severe shortages of educational staff, correctional staff, and firefighters throughout the state. And because the actuarial assumptions being used to price airtime failed to account for early retirements, as well as other factors, airtime was wildly underpriced for many years. Employees could purchase airtime often as much as 40 percent below the actual cost. That, in turn, increased unfunded liability in the pension system and imposed heavy unexpected financial obligations on public employers—exactly the opposite of what the Legislature had envisioned.

These facts came to light in the midst of the worst economic downturn in the state and nation since the Great Depression. That downturn hit California's public pension systems especially hard. For years, self-interested practices, overly generous promises whose true costs were often

shrouded by flawed actuarial analyses, and failures of public leadership had caused unsustainable public pension liabilities. When investment returns abruptly fell off a cliff, unfunded liabilities skyrocketed. Estimates placed unfunded pension liabilities in California in the hundreds of billions of dollars, far exceeding any other state in the nation.

Governor Brown and the Legislature responded to this crisis by enacting the Public Employees' Pension Reform Act of 2013 (PEPRA). PEPRA addressed the problem of unfunded liabilities primarily by reducing the benefits offered to new employees. But it also reformed some laws and practices enjoyed by current employees, including the law offering airtime for sale. Effective January 1, 2013, and after providing eligible employees one final 15-week opportunity to purchase airtime, PEPRA withdrew the airtime offer. Employees who had already purchased airtime, or did so before January 1, 2013, were not affected.

Cal Fire Local 2881 and several of its members (together, the Union) filed this lawsuit, alleging that the legislative repeal of the airtime statute violated the California Constitution's contract clause as applied to any employee hired before January 1, 2013. As both the trial court and Court of Appeal held, that claim lacks merit.

As a threshold matter, the statutory offer to sell airtime did not create a vested contract right. The Legislature is generally free to amend or repeal any law. A party alleging that the contract clause bars the Legislature from repealing a statute must provide clear and unequivocal evidence to overcome the presumption that the Legislature did not intend to create a vested contractual obligation. Here, there is no evidence that the Legislature intended to extend an *irrevocable* offer to purchase airtime and prevent future legislators from adjusting benefits for the fiscal health of the state's pension system. Unlike the narrow set of laws that have been held to impliedly create pension rights protected by the contract clause, the

statutory option to purchase airtime bears no resemblance to deferred compensation earned in exchange for work performed. The airtime purchase option was therefore not a "pension right," subject to heightened protection under the contract clause. Especially when unfunded liabilities of California's public pension systems are at record levels and rising rapidly, the Union's attempt to radically *expand* the scope of the vested rights doctrine should be rejected.

Furthermore, even if this Court were to assume that the Legislature created a vested right to purchase airtime, the Legislature was free to withdraw it. Withdrawing the offer did not substantially impair employees' right to a substantial or reasonable pension, or their reasonable expectations. And even a law substantially impairing a contract will generally stand if it was reasonable and necessary to serve an important public purpose. The law here easily meets this test. Ending the costly, imperfect practice of selling additional "service credit" untethered to service was necessary to re-align pension benefits with public service, eliminate a cause of premature retirements, and address a well-established source of unfunded liabilities never intended by the Legislature. And because the mere offer to sell airtime conferred no cash value, withdrawing the offer from employees who never purchased airtime did not materially disadvantage anyone.

This Court should affirm the Court of Appeal's judgment.

BACKGROUND

I. PUBLIC PENSIONS IN CALIFORNIA

Pensions represent compensation that is earned through service and deferred for payment during retirement. (*Packer v. Board of Retirement of Los Angeles County Peace Officers' Retirement System* (1950) 35 Cal.2d 212, 215.) The Public Employees' Retirement Law (PERL) provides the

legal framework for the pensions of most state employees and established the California Public Employees' Retirement System (CalPERS). (Cal. Const., art. XVI, § 17; Gov. Code, § 20120.)[1] CalPERS is the nation's largest public employee pension system, administering the pension benefits of most state government employees as well as employees of local governments that contract with CalPERS for the provision of pension benefits.

Public employee pensions are typically calculated using a formula set in statute that multiplies the number of years of service, final compensation, and an age-based multiplier, yielding a "defined benefit" for the employee. Most of the employees represented in this case by Cal Fire Local 2881 (and all the individual petitioners who have not yet retired) are expecting benefits using a "3%-at-50" formula. (§ 21363.4.)Under that formula, an employee who retires at age 50 with 30 years of service credit and $100,000 in final compensation would receive a $90,000 annual pension for the rest of his or her life (30 [years in service] x $100,000 [annual salary] x .03 [age-based multiplier] = $90,000 [annual pension]). A cost-of-living adjustment and purchasing power protection allowance further annually augment the employee's pension, ensuring that its value is not diminished by inflation. (§§ 21329, 21337.)

Pensions are funded by combining regular contributions from both the employee and his or her employer, and investing the funds over the employee's career. In theory, the contributions for that employee plus investment returns are supposed to cover the cost of the employee's pension benefits. In practice, however, it is difficult to predict how many years a given employee will work, what salary increases the employee will achieve during that span, what returns the investment of contributions will

[1] All further undesignated references are to the Government Code.

earn annually, and how long an employee will live after retiring. As a result, the respective monthly contributions of employees and employers are calculated using a number of general assumptions. (See e.g., Joint Appendix (JA) 312.) These assumptions sometimes prove inaccurate over time (JA 316-317 [noting need to adjust actuarial assumptions after study of "recent patterns of termination, death, disability, retirement, and salary increases"]), creating shortfalls between promised pension benefits and the revenues generated by member contributions and investment earnings. In such cases, the assumptions are adjusted, but the employer is responsible for covering the prior shortfalls and is legally obligated to make further contributions. (See, e.g., JA 283 [noting one way in which shortfalls may result, forcing an increase in employer liability].)

PERL also conforms itself to the requirements of the federal tax code to ensure CalPERS's federal tax-exempt status. (§ 21750 et seq.)

II. FEDERAL TAX LAW AUTHORIZES AIRTIME

Since 1997, federal tax law has permitted (but not required) public pension programs to offer employees who have worked for at least five years the opportunity to purchase additional years of service credit in order to artificially increase the base rate used to calculate a pension. (26 U.S.C. § 415(n)(3)(C).) This "nonqualified service credit" (*ibid.*) is commonly referred to as "airtime" "because it does not correspond to any service actually performed" (JA 264). Federal tax law further allows employees to purchase airtime using accumulated savings in tax-deferred retirement plans, such as 401(k) and 457 plans. (JA 256.)

In 1997, the Legislature enacted legislation to allow members of the California State Teachers Retirement System to purchase up to five years of airtime. (Ed. Code, § 22826 [Stats. 1997, ch. 569, § 2].)

III. The State Enacts the Airtime Law

In 2003, the Legislature passed laws expanding airtime beyond the teaching profession. As relevant here, AB 719 allowed members of CalPERS systems to purchase up to five years of airtime. (Assem. Bill No. 719 (2003-2004 Reg. Sess.) § 1.)[2] Governor Gray Davis signed AB 719 into law on October 11, 2003.

In its bill analysis for AB 719, CalPERS contrasted the proposed airtime program with programs in which purchase of retirement service credit is associated with time in service—such as time that an employee worked for the employer before the employer joined the CalPERS system. (JA 270.) In those programs, employees pay the equivalent of their normal retirement contributions, with interest, for the covered period, and the employer pays the balance. (*Ibid.*) Under AB 719, however, the time purchased would not correspond to time in service. And because employers would not "directly benefit" from the fictional time purchased, employees were supposed to pay both the employee *and* employer shares of the full present value of the benefit increase. (JA 270-271.) Consequently, CalPERS claimed that the program should cost public employers nothing. (JA 271.) Legislative analyses concurred in CalPERS's conclusion, and pointed out that proponents of the law claimed the same. (JA 259-260 [AB 719 Senate Floor Analysis]; JA 255 [AB 719 Assembly Committee Analysis].)

AB 719 was enacted as an amendment to the PERL. (§ 20909 [Stats. 2003, ch. 838, § 1]; see also § 20000.) Section 20909 extended to active employees with at least five years of service credit a one-time offer to

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[2] AB 55 similarly allowed members of systems established pursuant to the County Employees' Retirement Law of 1937 to purchase up to five years of airtime. (Assem. Bill No. 55 (2003-2004 Reg. Sess.) § 1.) Like AB 719, it was signed into law. (§ 31658 [Stats. 2003, ch. 261, § 3].)

purchase up to an additional five years of service credit, in one-year increments. (§ 20909, subds. (a), (e)(1).) To accept the offer, an employee had to pay "an amount equal to the increase in employer liability." (§ 21052; see also §§ 20909, subd. (b), 21050, subd. (a.). Notably, airtime could not be used to meet the minimum legal qualifications for retirement or any benefits, such as healthcare benefits, that are based on years of service. (§ 20909, subds. (b)-(c).)

CalPERS published an employee guide to purchasing airtime. (JA 273-281.) It informed members that they would "pay the entire cost of the estimated increase in their future retirement income." (JA 273.) It also notified them that the offer could not be accepted after separating from state service or if "repealed by future legislation." (JA 274.)

Seven years after enactment, CalPERS issued a report reviewing the airtime program. (JA 312-321.) The report noted that in the three-year period from June 30, 2004 to June 30, 2007, the vast majority of eligible employees did not elect to purchase airtime; still, over 33,000 employees did. (JA 313.) Analysis of the transactions showed that, due to inaccurate assumptions, employees were consistently and substantially underpaying for airtime. (JA 317-321 [showing airtime was underpriced, on average, by at least 11-28 percent].) It also found that employees who purchased airtime tended to retire sooner than employees who did not. Among school staff eligible for retirement, for example, those who bought airtime were *three* times more likely to have retired during the study period than those who did not. (JA 314.)

IV. THE STATE'S FISCAL CRISIS AND INCREASING UNFUNDED LIABILITIES LEAD TO REPEAL OF THE STATUTE

Around the time CalPERS reported the unintended consequences of the airtime program, California was wrestling with multi-billion dollar budget deficits year after year, and the staggering unfunded liabilities of

public pension programs across the state became a matter of increasingly urgent and widespread public concern. (See *San Joaquin County Correctional Officers Association v. County of San Joaquin* (2016) 6 Cal.App.5th 1090, 1095 (*County of San Joaquin*).) Some estimates placed unfunded liabilities in the hundreds of billions of dollars. (*Marin Association of Public Employees v. Marin County Employees' Retirement Association* (2016) 2 Cal.App.5th 674, 680-681 (*Marin County*), review granted Nov. 22, 2016 (S237460).)[3]

A 2011 report by the Little Hoover Commission advised the Governor and the Legislature that "California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently.'" (*County of San Joaquin*, *supra*, 6 Cal.App.5th at p. 1095, quoting Little Hoover Com., Public Pensions for Retirement Security (Feb. 2011) (*Little Hoover Com.*).) "'Unless aggressive reforms are implemented now,'" the report warned, "'the problem will get far worse, forcing counties and cities to severely reduce services and lay off employees to meet pension obligations.'" (*Ibid.*) The Commission urged the State to "exercise its authority—and establish the legal authority—to reset overly generous and unsustainable pension formulas for both current and future workers." (*Marin County*, *supra*, 2 Cal.App.5th at pp. 681-682, quoting Little Hoover Com., *supra*, at p. 53.)[4]

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[3] As many experts have noted, actual pension costs are frequently "shrouded." (See generally Glaeser & Ponzetto, *Shrouded Costs of Government: The Political Economy of State and Local Pensions* (April 2013) National Bureau of Economic Research < http://www.nber.org/papers/w18976.pdf > [as of Nov. 6, 2017).)

[4] The Commission emphasized that "[t]he problem . . . cannot be solved without addressing the pension liabilities of current employees. . . . To provide *immediate savings of the scope needed*, state and local

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In response to these concerns, Governor Edmund G. Brown Jr. proposed a Twelve Point Pension Reform Plan. (JA 387.)[5] The plan was designed to "put California on a more sustainable path to providing fair public retirement benefits" (*Ibid.* [fn. 1]). Point 10 called for ending the sale of airtime. Pensions should correspond to work "actually" performed, the Governor explained, not time that had merely been purchased. (*Ibid.*, quoting Governor's October 27, 2011 plan.) Employers and taxpayers "should not bear the burden of guaranteeing the additional employee investment risk that comes with airtime purchases." (*Ibid.*)

Like the Governor, the Legislature "heard, and agreed" with the concerns about the enormous unfunded liabilities of the state's pension systems, and enacted PEPRA in response. (*Marin County*, *supra*, 2 Cal.App.5th at p. 682 [citing § 7522 et seq., Stats. 2012, ch. 296].) The law adopted nine of the twelve points set forth in the Governor's reform plan, including the proposal to withdraw the airtime offer. (JA 387.)

Among other reforms, PEPRA barred public retirement systems from offering employees the option to purchase airtime, effective January 1, 2013 (§ 7522.46, subd. (a)), while authorizing them to honor all applications to purchase airtime received before January 1, 2013 (*id.*, subd. (b)). Thus, active public employees who had five years of service had a 15-week window in which to purchase airtime before the offer was

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(...continued)
governments must have the flexibility to alter future, unaccrued retirement benefits for current workers," "which at current levels is unsustainable."'" (Little Hoover Com., *supra*, at pp. v, 42, italics added.) The Little Hoover Commission's report is available at: http://www.lhc.ca.gov/sites/lhc.ca.gov/files/Reports/204/ Report204.pdf.

[5] The Governor's plan is available at: https://www.gov.ca.gov/docs/Twelve_Point_Pension_Reform_10.27.11.pdf.

withdrawn on PEPRA's effective date. Airtime that had already been purchased was unaffected.

STATEMENT OF THE CASE

The Union challenged section 7522.46, the statute withdrawing the airtime offer, by petition for writ of mandate. (JA 1-9.) It asked the trial court to direct CalPERS to accept airtime applications filed at any time by employees who were hired before PEPRA's effective date, arguing that the law impaired their vested pension rights in violation of the contract clause of the California Constitution. (JA 5-6, 8; JA 156-166.) The State of California, at the Governor's direction, intervened in the case to defend PEPRA's constitutionality. (JA 30-32.)

The trial court denied the Union's petition, holding that the option to purchase airtime was not a vested right. (JA 385-412.) The court found no evidence that the Legislature intended to create a contract right or for the airtime offer to serve as a form of deferred compensation. (JA 397, 400.) In the alternative, the court held that, even if section 20909 conferred a vested right, eliminating that right was a permissible modification to a pension plan. (JA 390-394.) Ending the sale of airtime aligned the pension system with its purpose of compensating employees for work performed. (JA 391-392.) And no longer selling airtime did not result in a disadvantage to employees to be offset. (See JA 392-394.)

The Court of Appeal affirmed. It viewed the airtime offer as "wholly distinct" from the pension paradigm of compensation in exchange for work performed, and agreed with the trial court that nothing in the text or legislative history of section 20909 demonstrated legislative intent to confer on public employees a contract right in the form of an irrevocable offer to purchase airtime. (*Cal Fire Local 2881 v. California Public Employees' Retirement System* (2016) 7 Cal.App.5th 115, 126-127 (*Cal Fire*).)

Like the trial court, the Court of Appeal also held that even if the Legislature had intended to confer a vested contract right, prohibiting new sales of airtime would not have unconstitutionally impaired a contract. (See *Cal Fire*, *supra*, at pp. 129-132.) Withdrawal of the airtime offer was "wholly reasonable" based on the record, and clearly "carried some material relation to the theory of a pension system and its successful operation." (*Id.* at p. 132, internal quotations omitted.) The court also rejected the argument that the State needed to provide a comparable benefit to offset the elimination of the airtime offer, concluding that the contract clause is not so "inflexible" that it categorically *requires* every impairment to be offset by comparable benefits. (*Id.* at p. 131.) In this case, the court pointed out, the responsibility was on employees to exercise the option "in order to avoid losing it"; any loss was therefore "a product of their own doing." (*Ibid.*) Moreover, airtime was not a benefit earned as compensation for work performed; it was a benefit employees purchased. (*Id.* at pp. 131-132.) As a result, eliminating the option to purchase that benefit did not implicate the same concerns as reducing a pension benefit. (*Id.* at p. 132; see also *id.* at p. 121.) Finally, the court noted that no employee's right to a "reasonable pension" had been lost because airtime was no longer being sold. (*Id.* at p. 132.)

This Court granted the Union's petition for review on April 12, 2017.

STANDARD OF REVIEW

This case presents questions of law, which this Court reviews de novo. (*Leider v. Lewis* (2017) 2 Cal.5th 1121, 1127.) "Generally, the trial court's [factual] findings will not be disturbed if substantial evidence supports the judgment." (*Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109, 1127.) All conflicts in the evidence should be resolved "in favor of the judgment." (*Ibid.*) In assessing the constitutionality of section 7522.46, "all intendments favor the exercise of the Legislature's

plenary authority: If there is any doubt as to the Legislature's power to act in any given case, the doubt should be resolved in favor of the Legislature's action." (*California Redevelopment Assn. v. Matosantos* (2011) 53 Cal.4th 231, 253, quotation marks omitted.)

ARGUMENT

Ending the sale of airtime fell within the Legislature's plenary authority to enact, repeal, and modify the laws. Public employees who never purchased airtime did not have a vested contract right under section 20909, and the Legislature could modify that right without violating the contract clause.

Like its counterpart in the U.S. Constitution, the California Constitution's contract clause prohibits the Legislature from enacting any "law impairing the obligation of contracts." (Cal. Const. art. I, § 9; compare *ibid.*, with U.S. Const. art. I, § 10, cl. 1 ["No State shall . . . pass any . . . Law impairing the Obligation of Contracts"].)[6] Analysis of a contract clause claim proceeds in two steps. (*Valdes v. Cory* (1983) 139 Cal.App.3d 773, 785.) First, the court must determine whether the party

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[6] This Court has called the two contract clauses "parallel." (*Allen v. Board of Administration of the Public Employees' Retirement System* (1983) 34 Cal.3d 114, 119 (*Allen II*).) It has blended the analysis of the two together and not distinguished between the policies animating them or treated one as more expansive than the other. (See, e.g., *id.* at pp. 119-125; *Olson v. Cory* (1980) 27 Cal.3d 532, 537-540.) And it has cited state and federal authorities interchangeably and without comment when considering cases alleging that laws impaired public employment contracts. (See, e.g., *Terry v. City of Berkeley* (1953) 41 Cal.2d 698, 703; *Legislature v. Eu* (1991) 54 Cal.3d 492, 525 (*Eu*) [relying on California cases to interpret and apply the federal contract clause].) The Ninth Circuit has observed that courts "apply the same analysis to claims brought under the Contract Clause of the United States Constitution and the California Constitution." (*Retired Employees Association of Orange County, Inc. v. County of Orange* (9th Cir. 2010) 610 F.3d 1099, 1102.)

asserting the claim has properly identified a contract. (*Ibid.*) If so, the court considers the Legislature's authority to modify the contract. (*Ibid.*; see also *Allen II*, *supra*, 34 Cal.3d at p. 119.) "The party asserting a contract clause claim has the burden of making out a clear case, free from all reasonable ambiguity, [that] a constitutional violation occurred." (*Deputy Sheriffs' Association of San Diego County v. County of San Diego* (2015) 233 Cal.App.4th 573, 578.) The court below correctly concluded that the Union's claim failed at each stage of this analysis.

I. THE OPTION TO PURCHASE AIRTIME WAS NOT A VESTED CONTRACT RIGHT

The Court of Appeal correctly observed that the "overarching issue" in this case is whether the Legislature "bestow[ed] upon plaintiffs and other CalPERS members a vested contract right to purchase airtime service credit." (*Cal Fire*, *supra*, 7 Cal.App.5th at p. 123.) The Union argues that such a right was clearly bestowed by the Legislature. According to the Union, the option to purchase airtime was a "pension right," and pension rights automatically vest upon the start of employment. (AOB 8-9.)

However, this argument is flawed in its premise. While the option to purchase airtime may have been related to pensions, it was not a "pension right," as this Court has long defined that term. The Union's argument that a pension right is any benefit or option offered in the governing public employee pension law at the time of an employee's service (AOB 9) ignores well-established law defining a pension right as a right to *deferred compensation*. Because the option to purchase airtime was not deferred compensation—a point conceded by the Union—it was not a pension right, and there is no basis for treating it as such. More fundamentally, the Union misapprehends the proper framework for analyzing vested rights, where vested rights are implied from statutes only if there is an unequivocal exchange of consideration. The Union's approach ignores that requirement,