No. S239958

IN THE SUPREME COURT 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.

SUPREME COURT
FILED

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After A Decision By The Court Of Appeal,
First Appellate District, Division Three, Case No. A142793
Alameda County Superior Court, Case No. RG12661622,
The Honorable Evelio Grillo, Judge Presiding

APPLICATION FOR PERMISSION TO FILE AMICUS CURIAE BRIEF AND PROPOSED BRIEF OF AMICUS CURIAE PACIFIC RESEARCH INSTITUTE IN SUPPORT OF INTERVENER AND RESPONDENT STATE OF CALIFORNIA

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APPLICATION FOR LEAVE TO FILE AMICUS CURIAE BRIEF

Pacific Research Institute ("PRI") respectfully requests permission to file the attached amicus curiae brief in support of the Intervener and Respondent, the State of California, pursuant to California Rules of Court, rule 8.520(f).[1]

Founded in 1979 and based in San Francisco, PRI is a nonpartisan, nonprofit section 501(c)(3) organization that champions liberty and free-market solutions to the issues that impact the daily lives of all Americans. Among PRI's many endeavors is its research into (1) pension reform, (2) health care reform, (3) reform of the California economy, and (4) education reform. Its activities include research papers on public policy issues, news columns and articles, featured speakers, media commentary and podcasts, invited legislative testimony, and amicus curiae briefs.

PRI's study of California's public employee pension systems suggests that there is a serious risk of unfunded pension liabilities crowding out other important services for California citizens, which, in turn, would require a substantial increase in taxes (with its concomitant, adverse impact on the

---

[1] No party or any party's counsel authored this amicus brief, in whole or in part, or made a monetary contribution intended to fund the preparation or submission of this brief. The following persons, however, made monetary contributions intended to fund in part the preparation of the brief: George H. Hume, G. Leonard Baker, Jr., Tench Coxe, and Sandy Dean. (See Cal. Rules of Court, rule 8.520(f)(4).)

economy) or a substantial reduction in services. PRI submits this amicus curiae brief because a ruling in this case against the State of California would hinder the Legislature's ability in the future to exercise its constitutional authority to address these unfunded liabilities and control the State's budget.

Accordingly, PRI respectfully requests leave to file this amicus brief in order to address the following topics:

1. The magnitude and consequences of California's unfunded pension liabilities;

2. The impact of an adverse ruling in this case on the Legislature's and Governor's efforts to repeal or control pension spiking techniques;

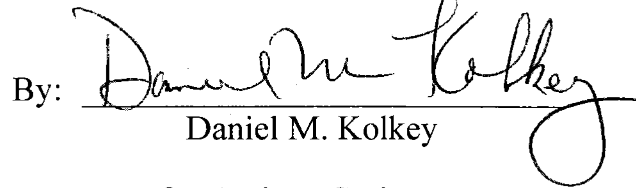
3. Harmonization of the case law governing the U.S. and California Constitutions' contract clauses with the case law governing the impairment of public employee pension rights, given that California's case law regarding the impairment of pension rights has strayed from contract clause jurisprudence; and

4. New and refined arguments in support of the Legislature's authority to repeal the statutory offer to purchase pension "airtime" credits.

Dated: February 21, 2018

Respectfully submitted,

GIBSON, DUNN & CRUTCHER LLP

By: 

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I. INTRODUCTION

California's public employee pension systems are in staggering financial trouble. Fueled by expanded retiree benefits in the late 1990s and the economic crisis of 2008-2009, pensions for California's public employees – including the California Public Employees' Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS") – now face a shortfall in the *hundreds of billions* of dollars. Without dramatic fixes, California will be faced with the dilemma of either imposing the *largest* tax increase in its history or making devastating spending cuts, including service reductions and layoffs. The only way out is to recognize that not all legislation relating to public employee benefits creates vested contract rights and to not treat the California Constitution's contract clause as applying differently to pension contracts than contracts in general.

Unfortunately, the California Constitution's contract clause has proven complicated to navigate in making changes to the public employee pension system, as evidenced by this case. Although the contract clauses in the U.S. and California Constitutions are supposed to be interpreted *similarly*, California cases have strayed from applying these well established standards when addressing public pension rights. For instance, in the context of public employee pensions, some California cases have *assumed vested contract rights* without first finding unambiguous evidence of a legislative

intent to grant such *contract* rights. Other California cases have failed to provide guidance as to what type of contractual impairment is *substantial* for purposes of finding a contract clause violation and have suggested that permissible substantial impairments should be accompanied by "comparable new advantages" (*Betts v. Board of Administration of Public Employees' Retirement System* (1978) 21 Cal.3d 859, 864 (*Betts*)) when logically there cannot be a substantial impairment if there is a *comparable* new advantage.

In this brief, PRI will demonstrate that the Legislature's repeal of the option to purchase airtime credits in the Public Employees' Pension Reform Act of 2013 ("PEPRA") is not a violation of the contract clause for the following reasons:

First, a public employee asserting a vested contract right must show that the Legislature "clearly and unequivocally expressed" the intent to grant a contract right. (*Retired Employees Ass'n of Orange County, Inc. v. County of Orange* (2011) 52 Cal.4th 1171, 1185 (*Retired Employees*).) Here, no legislative intent to grant *a contract* right was expressed or implied by the mere *statutory offer* to buy airtime: Unexercised offers, by their very nature, are not intended to create contracts. And the airtime credits were specifically intended to be sold *without any cost to the State*, thus making it highly unlikely that the Legislature intended to create a vested right *against* the State to sell them when it turned out they were costing the State money.

Second, even if the statutory *offer*, in and of itself, created a vested *contract* right, an impairment of a contract right must be *substantial* in order to violate the contract clause. (*San Francisco Taxpayers Ass'n v. Board of Supervisors* (1992) 2 Cal.4th 571, 584 (*San Francisco Taxpayers*); *General Motors Corp. v. Romein* (1992) 503 U.S. 181, 186 (*General Motors*).) The withdrawal of the *offer* to buy airtime credits could not be a *substantial* impairment of *pension rights* because (1) "[p]ension rights . . . are deferred compensation earned immediately upon the performance of services for a public employer" (*Miller v. State of California* (1977) 18 Cal.3d 808, 814 (*Miller*)), and airtime credits were not earned as a form of deferred compensation, such that withdrawal of the offer to buy airtime could substantially impair the employee's pension rights, and (2) airtime credits were not a substantial pension benefit because they were to be paid *wholly* by the employee.

Third, even if the statutory offer to sell airtime credits granted a vested contract right, *and* its repeal was a substantial impairment, impairment of a contract is constitutional if it is *reasonable* and *necessary* to serve an important public purpose. (*U.S. Trust Co. of New York v. New Jersey* (1977) 431 U.S. 1, 22-23 (*U.S. Trust*); *Allen v. City of Long Beach* (1955) 45 Cal.2d 128, 131 ("*Allen I*").) Ending the airtime credit program was reasonable and necessary to serve an important public purpose because the program was an

unearned benefit that was already costing the State significant additional sums in an already-underfunded system.

Fourth, the case law suggests that to be sustained as a reasonable change in a pension plan, any change that results in a disadvantage to employees "should be accompanied by comparable new advantages" (*Allen I*, *supra*, 45 Cal.2d at p. 131), but this factor has been misapplied. The additional element of "comparable new advantages" – which some lower courts have interpreted as a recommendation and not a mandate – can only be reconciled with contract clause jurisprudence if the *comparable* advantage offsets the substantial nature of the impairment, such that it is no longer substantial and thus not a violation of the contract clause. There should be no need to require or encourage a comparative new advantage if (1) the impairment is not substantial in the first instance, or (2) the substantial impairment is both reasonable and necessary to protect the solvency of previously earned pension benefits.

For all of these reasons, the Court should reject Petitioners' challenge to the Legislature's lawful authority to repeal the statutory offer of airtime credits, affirm the Court of Appeal's decision, and clarify the contract clause jurisprudence.

II. CALIFORNIA FACES A DANGEROUSLY UNDERFUNDED PENSION SYSTEM THAT THREATENS THE STATE'S ENTIRE ECONOMY

A. California's Pension Benefits Are Unsustainable.

California's pension systems are facing an imminent fiscal crisis. The State expanded retiree benefits in 1999 (Sen. Bill No. 400 (1999-2000 Reg. Sess., Stats. 1999, Ch. 555), relying on the extraordinary returns in the stock market associated with the technology bubble of the 1990s. But the assumptions behind those enhanced benefit levels proved incorrect.

In addition, California has consistently failed to make sufficient annual contributions to its pension plans over the past decade. As described in a study by PRI, in 2013, California contributed only 70% of the actuarially required annual contribution for its state-run pension systems, and had not been covering the actuarially required contributions for over a decade. (Wayne Winegarden, *California's Pension Crowd-Out* (2016) pp. 7, 18, citing The Pew Charitable Trusts, *The State Pensions Funding Gap: Challenges Persist* (2015).) These twin problems – unwise expansion and contribution shortfalls – have led to massive underfunding. (Winegarden, *supra*, at pp. 7-8.)

The magnitude of the unfunded pension liability problem in California is "staggering," leaving some commentators to question whether the State should declare bankruptcy. (Maria O'Brien Hylton, *Combating Moral*

Hazard: The Case for Rationalizing Public Employee Benefits (2012) 45 Ind. L. Rev. 413, 444.)

According to PRI, as of 2014, California had around $170 billion in unfunded pension liabilities for its state-run plans, equal to 7 percent of total state GDP, or *125 percent of total state tax revenues*! (Winegarden, *supra*, at pp. 9, 18-19.)[2] If one accounts for the risk that the rate of expected return could be lower than anticipated, California's unfunded pension liabilities could be as high as $300 to $600 billion, or between 13 and 28 percent of total state GDP as of 2014. (*Id.* at pp. 10, 24-27.)

Although CalPERS's financial reports declared its total unfunded liabilities as $38.6 billion as of 2008, a 2010 analysis by the Stanford Institute for Economic Policy Research estimated that this figure, when properly adjusted for investment risk, was in fact a staggering $239.7 billion – over six times the official deficit. (Howard Bornstein et al., *Going for Broke: Reforming California's Public Employee Pension Systems*, Stanford Institute for Economic Policy Research ("SIEPR") (April 2010) p. 2, cited in *Marin Ass'n of Public Employees v. Marin County Employees' Retirement Ass'n* (2016) 2 Cal.App.5th 674, 681, review granted Nov. 22, 2016, S237460 (*Marin Ass'n of Public Employees*).)

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[2] That figure was $174 billion as of 2015. (Winegarden, *supra*, as updated Jan. 15, 2018.)

The same analysis found that CalSTRS had risk-adjusted unfunded liabilities of $156.7 billion (despite stating its unfunded liabilities as only $16.2 billion on its financial reports). (Bornstein, *supra*, at p. 2.)[3]

In total, the risk-adjusted unfunded liabilities for the state-run CalPERS, CalSTRS, and University of California pension systems are a staggering $425.2 billion. (Bornstein, *supra*, at p. 2.) This figure falls squarely within PRI's maximum range of between $300 billion to $600 billion. (Winegarden, *supra*, at pp. 10, 27.)

Moreover, California's county employee retirement systems and independent local government pension systems add another risk-adjusted $195.2 billion in unfunded liabilities to the State's future pension burdens. (Nation, *The Funding Status of Independent Public Employee Pension Systems in California*, Stanford Institute for Economic Policy Research (Nov. 2010) p. 2, cited in *Marin Ass'n of Public Employees*, *supra*, 2 Cal.App.5th at p. 681.)

In sum, researchers using the government's assumptions about the correct discount rate have estimated unfunded pension liabilities in state-run

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[3] As of 2016, the Legislative Auditor's Office estimated that the unfunded liabilities for CalSTRS totaled $97 billion, well above CalSTRS's own figure, having grown by $21 billion in the prior year alone. (*CalSTRS Funding: An Update*, California Legislative Analyst's Office (May 2017) p. 1.)

systems to be between $130 and $217 billion, and researchers adjusting those assumptions for risk have placed the sum as high as $640 billion. (Winegarden, *supra*, at pp. 25-28.)[4] The bottom line is not in dispute: Each study demonstrates that the scope of the problem is massive.

B. Unfunded Pension Benefits Will Crowd Out Necessary Services.

These unfunded pension liabilities are a "ticking fiscal time bomb for state and local governments." (Jack M. Beermann, *The Public Pension Crisis* (2013) 70 Wash. & Lee L. Rev. 3, 13.)

The problem is particularly acute in California. In 2011, the Little Hoover Commission – an independent state government oversight agency – found that the State's public pension system lacks discipline, oversight, and accountability, that "[t]he math doesn't work," and that if the State fails to address its unfunded pension liability problem, "[p]ension costs will crush government." (Little Hoover Com., *Public Pensions for Retirement Security* (Feb. 2011) pp. iii-iv.) Digging out of the current pension liability hole will require drastic action.

According to PRI's analysis, covering the state's unfunded pension liabilities through tax revenues, rather than reform, would require the *largest*

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[4] But as of fiscal year 2013, the Stanford Institute for Economic Policy Research estimated that the total risk-adjusted pension debt of California, using a 3.25% discount rate, including state and county pension systems, had grown to $992.4 billion. (SIEPR, *California Pension Tracker* http://www.pensiontracker.org/index.php [as of Jan. 23, 2018].)

tax increase in California history – $28.3 billion *per year* for the *next 30 years*. (Winegarden, *supra*, at pp. 10-11.) And that tax increase would cause California's economy to *shrink 21 percent* over the next 30 years, compared to its current projected growth (*ibid.*), costing residents their *future* economic opportunities – in order to pay for their *prior* obligations.

Alternatively, California could choose to cut total state and local spending more than 8% across the board. (Winegarden, *supra*, at p. 11.) Those cuts would affect every aspect of the services that the State provides to its citizens, including (among other things) "a $5.4 billion cut to the school budget, a $4.9 billion cut in spending on income support programs, a $2.9 billion cut to the higher education budget, and a $1.9 billion cut to California's hospital systems," compared to current projections. (*Ibid.*) Or California could make the necessary payments "by eliminating all expenditures on hospitals and fire services . . . ; or eliminat[ing] all expenditures on police protection, parks and recreation, and judicial and legal expenditures." (*Id.* at p. 40.) In short, California's state, county, and local governments would "have to pull heavily from other parts of their budgets to afford the bill." (Little Hoover Com., *supra*, at p. 24.)

III. THE LEGISLATURE NEEDS THE FLEXIBILITY TO CURTAIL PENSION SPIKING AND PROTECT THE SOLVENCY OF THE PUBLIC PENSION SYSTEM

Pension spiking *must* be addressed as part of any plan to stabilize California's pension system. The 2011 Little Hoover Commission report

stated bluntly that "[t]he spiking games must end," noting that benefit levels for top-earning managers have caused "considerable anger in the public," and that the problems with pension spiking in the State's pension system have "eroded taxpayer support." (Little Hoover Com., *supra*, at p. 46.)

To fix the spiking problem, the Commission stated that "[p]ensions must be based only on actual base salary" averaged over multiple years, and "not padded with other pay for clothing, equipment or vehicle use, or enhanced by adding service credit for unused sick time, vacation time or other leave time." (Little Hoover Com., *supra*, at p. 46.)

Later in 2011, Governor Jerry Brown released a twelve-point reform plan for the public pension system, including recommendations to require that the compensation used to calculate benefits be based on a three-year average in order to discourage "games and gimmicks in the last year of employment" and to require that those calculations use "the normal rate of base pay," thereby preventing benefits from being "manipulated by supplementing salaries with special bonuses, unused vacation time, unused overtime and other pay perks." (Gov. Jerry Brown, *Twelve Point Pension Reform Plan* (Oct. 27, 2011) at pp. 2-3.)

In 2012, the Legislature passed PEPRA, which included a range of reforms for the pension system, particularly for employees hired after January 1, 2013, as a step to curtail pension spiking impacting CalPERS and CalSTRS. Among PEPRA's reforms are the following:

First, the new law eliminated the offer of airtime credits in the CalPERS system. The airtime credit program had allowed members to increase their pension benefits by purchasing credits for extra years of service unrelated to their *actual* years of service with the State. Moreover, CalPERS members had been allowed to purchase airtime credits below actual cost – despite a statutory mandate that the credits be sold at no cost to the State – giving certain employees a windfall that the Legislature never intended.

Second, PEPRA altered the method by which the "salary base" was calculated for new members entering the system after January 1, 2013, eliminating the inclusion of one-time payments for determining an employee's pension benefits. For instance, PEPRA calculates the "final compensation" salary base for new members as the average of their compensation over a three-year period (Gov. Code, § 7522.32),[5] thereby tying pension benefits to the normal compensation for the employee's services without the use of one-time salary gimmicks. It also limited "pensionable compensation" for new CalPERS members to the "normal monthly rate of pay or base pay" paid to all similarly situated employees, and explicitly excluded several specific forms of compensation that would

[5] Unless specified otherwise, all subsequent statutory references are to the Government Code.

previously have been used to spike pension benefits. (§ 7522.34, subds. (a), (c).)

PEPRA also added explicit anti-spiking provisions that allow the CalPERS board to exclude from a salary base of new members entering the system after January 1, 2013, any compensation that is "paid to increase a member's retirement benefit" or is otherwise inconsistent with the requirement that pensions be based on the normal base pay. (§ 7522.34, subds. (c)(1), (11), (12).)

Third, PEPRA eliminated the ability of new CalPERS members to inflate their final-year salaries by counting payments for unused vacation, annual leave, or sick time. (§ 7522.34, subd. (c)(5); see *San Diego County Employees Retirement Ass'n v. Superior Court* (2011) 196 Cal.App.4th 1228, 1243-44 [describing this form of pension spiking].)

Fourth, PEPRA eliminated a program called Employer Paid Member Contributions ("EPMC"), under which an employer's contribution to the pension system could be counted as employee compensation in the employee's final year. A 2014 audit by the State Controller's Office found that dozens of entities within CalPERS were using this form of pension spiking and estimated that the EPMC program had created up to $796 million in additional pension liabilities over twenty years. (Betty Yee, *Controller Finds Pension Spiking Vulnerabilities at CalPERS*, California State

Controller (Sept. 9, 2014), http://www.sco.ca.gov/PDF-Var/eo_pressrel_15451.pdf.)

PEPRA also eliminated the airtime credit program within CalSTRS, and enacted salary-base reforms for new CalSTRS members similar to the reforms applicable to new CalPERS members. (See Educ. Code, § 22119.3, subd. (b).)

While petitioners seek to isolate the costs saved by the elimination of the airtime credits program alone, PEPRA's reforms must be viewed as a package of reforms that together advance the Legislature's goal of curtailing abuses of the public pension system that have further undermined its solvency.

IV. THE FEDERAL AND STATE CONSTITUTIONS' CONTRACT CLAUSES ARE SIMILARLY INTERPRETED

A. The Federal Standard.

Under the United States Constitution, no state may pass a "law impairing the obligation of contracts." (U.S. Const., art. I, § 10, cl. 1.) Determining whether this prohibition is violated entails a multi-part inquiry:

First, there must be a contract that is impaired. (U.S. Const., art. I, § 10, cl. 1.)

Second, the court determines "whether the state law has, in fact, operated as a substantial impairment of a contractual relationship." (*Allied Structural Steel Co. v. Spannaus* (1978) 438 U.S. 234, 244 (*Allied Structural*