

Statutes as Contracts? The “California Rule” and Its Impact on Public Pension Reform

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ABSTRACT: State and local retirement plans are underfunded by trillions of dollars, at a time when many states are facing decreased revenues and increased social needs. As a result, many states are actively considering how best to address the problem of state and local pension plan underfunding given their limited resources. In many states, however, courts have held that the statutes establishing state retirement systems created contracts between the state and employees that prohibit the state from making any detrimental changes to the benefits provided to current employees within such systems, even on a prospective basis. This Article examines the development of such a rule in the California courts, a rule that has been widely influential in this area of law, as evidenced by the fact that courts in twelve other states have followed the California Supreme Court’s holdings. This Article demonstrates that by holding that benefits not yet earned are contractually protected, without explaining the basis for finding that such a contract exists, California courts have improperly infringed on legislative power and have fashioned a rule that is inconsistent with both contract and economic theory.

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INTRODUCTION

Despite balanced-budget requirements,¹ nearly every state in this country carries significant off-balance-sheet debt in the form of underfunded public employee pension liabilities.² The aggregate amount of this debt is estimated to be \$3 trillion, with some estimates as high as \$5 trillion.³ While liabilities vary significantly from state to state, several states have unfunded liabilities of hundreds of billions of dollars.⁴ The amount of money necessary to fully fund state and local employees' pension benefits is staggering, particularly at a time when the general economy is struggling and state revenues are down.⁵ To put it in perspective, if one assumes an unfunded liability of \$3 trillion, every household in the United States would need to contribute \$27,000 to achieve full funding.⁶ Thus, in order to fully fund state pension plans over the next thirty years, financial economists estimate that contributions to such plans would need to increase by a factor of 2.5, an amount equal to 14.2% of state revenues.⁷ And in some states an even greater percentage of state revenue would be necessary.⁸

Against this background, it is not surprising that many states are exploring options that will decrease their retirement plans' unfunded

1. For an overview of state balanced-budget requirements, see NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS (2010), available at <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>.

2. For an overview of states' unfunded pension liability, see ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOS. COLL., THE FUNDING OF STATE AND LOCAL PENSIONS IN 2010 (2011), available at http://crr.bc.edu/images/stories/slp_17_508.pdf.

3. Robert Novy-Marx & Joshua Rauh, *The Crisis in Local Government Pensions in the United States*, in GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE FINANCIAL CRISIS 47, 48 (Yasuyuki Fuchita et al. eds., 2011).

4. See BRYAN LEONARD, STATE BUDGET SOLUTIONS, JUST HOW BIG ARE PUBLIC PENSION LIABILITIES? (2011), available at http://www.statebudgetsolutions.org/doclib/20110304_StatePensionLiabilityMarch4.pdf (summarizing the results of several different estimates of public pension liabilities, which put California's unfunded liability anywhere from roughly \$60 billion to \$398 billion); see also HOWARD BORNSTEIN ET AL., STANFORD INST. FOR ECON. POLICY RESEARCH, GOING FOR BROKE: REFORMING CALIFORNIA'S PUBLIC EMPLOYEE PENSION SYSTEMS (2010), available at http://siepr.stanford.edu/system/files/shared/GoingforBroke_pb.pdf (estimating California's unfunded pension liabilities at half a trillion dollars).

5. See, e.g., LUCY DADAYAN & DONALD J. BOYD, NELSON A. ROCKEFELLER INST. OF GOV'T, NO. 83, TAX REVENUES FINISHED 2010 STRONG; GROWTH CONTINUES IN EARLY 2011 3-5 (2011), available at http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-04-19-SRR_83%20rev.pdf (finding that while state revenues were increasing in 2010, the majority of states had revenue levels in 2010 that were equal to or lower than revenues in 2007).

6. Novy-Marx & Rauh, *supra* note 3, at 72.

7. Robert Novy-Marx & Joshua D. Rauh, *The Revenue Demands of Public Employee Pension Promises* 1 (Simon School Working Paper No. FR 11-21, June 2011), available at <http://www.kellogg.northwestern.edu/faculty/rauh/research/RDPEPP.pdf>.

8. See *id.* at 40 tbl.5 (estimating that California, for example, would need to contribute 17.7% of tax revenue to public employee pension funds over the next thirty years to fully fund the state's plans).

liability without also requiring that an untenable amount of state revenue be devoted to such plans.⁹ For example, one such option is to decrease the retirement benefits the state offers to current state employees going forward. Such a change would not affect the pension benefits an employee has already earned through services rendered, but would only change the generosity or form of benefits that employees would earn after the date of the change.¹⁰ Taking such action would reduce a plan's future liabilities and therefore decrease the future funding needs of the plan.¹¹

In many states, however, courts have held that the same statutes that established state retirement systems also created a contract between the state and its employees that cannot be impaired.¹² In particular, courts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that they do so as of the first day of employment.¹³ The practical result of this rule is that pension benefits for current employees cannot be detrimentally changed, even if the changes are purely prospective. Thus, the only readily available option for changing employee pension benefits in these states is to limit such changes to new hires.¹⁴

This so-called California Rule regarding pension modifications is surprising for a number of different reasons. First, it runs contrary to the well-established legal presumption that statutes do not create contractual rights absent clear and unambiguous evidence that the legislature intended to bind itself.¹⁵ Second, courts interpreting the California Rule have held that the contract protects not only accrued benefits (a relatively uncontroversial position) but also the rate of future accrual.¹⁶ This

9. For an overview of pension reform efforts under consideration in 2011, see RON SNELL, NAT'L CONFERENCE OF STATE LEGISLATURES, SELECTED 2011 STATE PENSION REFORM PROPOSALS (2011), available at <http://www.ncsl.org/documents/employ/StatePensionReformProposals2011March15Cumulative.pdf>.

10. For example, a state with a traditional pension plan that provided benefits equal to 3% of compensation each year might reduce the formula going forward to 1% a year. Or a state might freeze accruals within a traditional pension plan and adopt a defined contribution plan in its place.

11. See Novy-Marx & Rauh, *supra* note 7, at 8, 29–30 (discussing the effect of eliminating future pension accruals on the funding needs of plans).

12. For an overview of state approaches to public pension protection, see Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617 (2010).

13. See *infra* Part II.

14. Another option would be for the state to argue that changes to current employees' benefits are reasonable and necessary to serve an important public purpose, which would allow the state to make changes despite the restrictions of the Contract Clause. This argument, however, is fraught with significant legal uncertainty and is therefore not a realistic option for most states. See Part I.C for a discussion of the Contract Clause and permissible changes thereunder.

15. Nat'l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co., 470 U.S. 451, 465–66 (1985).

16. *Legislature v. Eu*, 816 P.2d 1309, 1333–35 (Cal. 1991).

interpretation is contrary to federal Contract Clause jurisprudence, which holds that prospective changes to a contract should not be considered unconstitutional impairments.¹⁷ Third, not only is this interpretation contrary to general contract theory, it also appears to create economic inefficiency, in that it fixes in place one part of an employee's compensation. Under existing law, states can terminate employees, lower their salaries, and change their fringe benefits absent explicit agreements to the contrary.¹⁸ Yet California courts have held that even though the state can terminate a worker, lower her salary, or reduce her other benefits, the state cannot decrease the worker's rate of pension accrual as long as she is employed. This framework can be welfare reducing. Given the option, an employee may prefer to accept lower future pension accruals in return for avoiding termination or a reduction in current compensation, but such deals are hard to accomplish in a system that protects the right to future accruals. It should also be noted that the protections the California Rule appears to offer are illusory, given that it simply forces a state that needs to reduce costs to do so in some area other than pension accruals—for example, through layoffs or salary reductions. Viewed holistically, the California Rule simply does not protect employees' economic interests, and in some cases the rule may even harm the interests of the very employees it is meant to protect.

This Article provides a historical look at the California Rule, tracing its development over nearly ninety years of case law. The Article focuses on California for a number of reasons. First and foremost is California's influential role in establishing one of the most protective legal approaches for public employee pension benefits of any state in the country, developed entirely through common law. Second, California itself is in the midst of evaluating options for dealing with underfunded public pension plans.¹⁹ With an unfunded liability that is conservatively estimated to be in the hundreds of billions of dollars, the challenges and tensions mentioned are very real in California, as they are in many other states.

It should be noted at the outset that the purpose of this Article is not to make the policy argument that future pension accruals *should*, in fact, be reduced. Rather, it presents a critique of the California Rule and argues that, consistent with both federal and state law, changes to future pension

17. See, e.g., *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362, 372 (2d Cir. 2006); *Robertson v. Kulongoski*, 359 F. Supp. 2d 1094, 1100 (D. Or. 2004); *Howell v. Anne Arundel Cnty.*, 14 F. Supp. 2d 752, 755–56 (D. Md. 1998).

18. *Mississippi ex rel. Robinson v. Miller*, 276 U.S. 174, 178–79 (1928); *Butterworth v. Boyd*, 82 P.2d 434, 439 (Cal. 1938).

19. See, e.g., John Diaz, *Pension Reform—Finally?*, S.F. CHRON. (Jan. 30, 2011), <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2011/01/30/IN6C1HE931.DTL>; Alana Semuels, *State Pensions Face Steep Shortfalls, Report Concludes*, L.A. TIMES (Oct. 20, 2010), <http://articles.latimes.com/2010/oct/20/business/la-fi-milken-institute-20101020>.

accruals should be *legally* permissible absent clear and unambiguous evidence that the legislature intended to create a contract. It is up to the state and its citizens to determine how best to approach the problem of underfunded public pensions. This Article merely suggests that this alternative deserves to be part of the states' discussion.

This Article proceeds in Part I to provide background on public employee pension plans generally, as well as federal interpretations of statutes as contracts and their corresponding constitutional protection. Part II then traces the historical development of the California Rule, noting how various courts have, over the years, amended and added to the rule, and how the rule fits into other areas of state law. Finally, Part III critiques the California Rule and demonstrates how it fails to establish the necessary legislative intent to form a contract, is inconsistent with contract theory, and is an economically inefficient and illusory protector of employees' expectations. Part III then concludes with some thoughts regarding the practical impact of the California Rule as legal precedent.

I. BACKGROUND

A. PUBLIC EMPLOYEE PENSION PLANS

Pension plans for state employees have over 19 million participants and over \$2.5 trillion in assets.²⁰ For about a quarter of the individuals covered by such plans, these plans represent the employee's primary source of retirement income, because their employer has opted out of the federal Social Security system.²¹ Unfortunately, many of these plans are significantly underfunded.²² Moreover, these plans are coming under increasing scrutiny by the broader public not only because of the financial strain they put on state governments but also because of the perceived generosity of benefits, particularly in comparison to those offered in the private sector.²³ As states grapple with how to both improve plan funding and also, in some cases, to

20. CONG. BUDGET OFFICE, THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS 1 (2011), available at <http://www.cbo.gov/ftpdocs/120xx/doc12084/05-04-Pensions.pdf> (reporting the results of a survey that included 85% of state and local pension assets, finding those plans held roughly \$2.6 trillion in assets in 2009).

21. GOV'T ACCOUNTABILITY OFFICE, NO. GAO-08-248T, SOCIAL SECURITY: ISSUES REGARDING THE COVERAGE OF PUBLIC EMPLOYEES 3 (2007), available at <http://www.gao.gov/new.items/do8248t.pdf> (statement of Barbara D. Bovbjerg, Director of Education, Workforce, and Income Security).

22. See CONG. BUDGET OFFICE, *supra* note 20; MUNNELL ET AL., *supra* note 2.

23. See, e.g., JEFFREY KEEFE, ECON. POL'Y INST., BRIEFING PAPER NO. 276, DEBUNKING THE MYTH OF THE OVERCOMPENSATED PUBLIC EMPLOYEE: THE EVIDENCE (2010), available at <http://www.epi.org/page/-/pdf/bp276.pdf?nocdn=1> (finding that public employees are undercompensated compared to their peers in the private sector); Dennis Cauchon, *Wisconsin One of 41 States Where Public Workers Earn More*, USA TODAY (Mar. 2, 2011, 10:56 AM), http://www.usatoday.com/news/nation/2011-03-01-1Apublicworkers01_ST_N.htm (finding that public employees earn more than their private counterparts in forty-one states).

reform benefit structures in order to better meet policy goals going forward, they are limited in many states by legal restrictions and legal uncertainties that appear to take some reform options off the table.

While public employee pension plans are typically tax-qualified retirement plans subject to Internal Revenue Code requirements, the protection of participant benefits under such systems is left entirely to state law.²⁴ As a result, the legal protections vary significantly from state to state and are often the product of less-than-clear common law.²⁵

Historically, pensions for public employees were viewed as gratuities. As one court infamously explained,

[a] pension is a bounty springing from the graciousness and appreciation of sovereignty. It may be given or withheld at the pleasure of a sovereign power. Because one is placed upon a pension roll under a valid law is no reason why that law may not be repealed and the pension cease.²⁶

In the early to mid-twentieth century, however, nearly every state moved away from this view of public pensions.²⁷ In some cases, the courts acknowledged that the shift was required by state constitutional provisions that prohibited the state from giving gifts to private citizens.²⁸ Most of the state courts that rejected the gratuity approach embraced the view that public pension plans created some type of contractual relationship between the state and the employee.²⁹ In a minority of states, courts rejected the contract approach and instead characterized the interest as a property interest.³⁰

As will be discussed in more detail below, state court holdings that public pensions create contracts are significant because the federal Constitution prohibits state actions that impair contracts,³¹ and many state constitutions contain similar prohibitions.³² Therefore, to the extent an

24. I.R.C. §§ 411(e)(1), 414(d) (2006).

25. See generally Monahan, *supra* note 12.

26. Eddy v. Morgan, 75 N.E. 174, 178 (Ill. 1905).

27. See Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994–1003 (1977) (explaining the evolution of the law from a gratuity approach to a contract approach).

28. See, e.g., Yeazell v. Copins, 402 P.2d 541, 543 (Ariz. 1965); Bender v. Anglin, 60 S.E.2d 756, 760 (Ga. 1950); Bakenhus v. City of Seattle, 296 P.2d 536, 538 (Wash. 1956).

29. See Monahan, *supra* note 12, at 638–39 (finding in a study of twenty-four states that the majority had adopted a contract-based approach to public pensions).

30. See *id.* (finding only two of twenty-four states studied had adopted a property-based approach).

31. U.S. CONST. art. I, § 10, cl. 1.

32. See, e.g., CAL. CONST. art. I, § 9; see also Nicholas J. Houpt, *Shopping for State Constitutions: Gift Clauses as Obstacles to State Encouragement of Carbon Sequestration*, 36 COLUM. J. ENVTL. L. 359, 379 (2011) (finding that “[f]orty-six states have some form of [constitutional] limit” on state gifts).

employee or her beneficiary has a contractual right to public pension benefits, that benefit cannot be substantially impaired unless the state is acting under its limited police power.³³

Despite the popularity of the contract-based approach to public pensions, there is significant variation among the states with respect to how they apply the contractual approach. In particular, the states disagree on when the contract is formed and which terms the contract covers and protects. At one end of the spectrum are the states that hold that a contract is formed on the first day of employment and, therefore, the contract protects the employee from any changes that detrimentally affect the pension the employee would have earned under the formula in place on the first day of employment.³⁴ On the other end of the spectrum are those states that hold that a contract is not formed until the participant has retired and begun receiving benefits, allowing the state to make changes freely prior to that point.³⁵

Among all the states, California has been perhaps the most influential in developing this area of the law. California courts have not only held that public pensions create a contract but also that the contract is formed on the employee's first day of employment.³⁶ While the courts permit reasonable modifications of the contract prior to retirement, they do not allow any disadvantageous modifications unless the modifications are offset by comparable new advantages.³⁷ This test is often referred to as the "California Rule." As one can see, this approach is far more protective of employees' pension rights than, for example, a holding that a contract right exists only after the employee has satisfied all of the conditions necessary (such as attainment of a specified age and years of service) to receive the benefits.

California was one of the first states to hold that statutes establishing pension programs created any type of contract, and it is clear that many states, in moving away from the gratuity approach, found California's decisions to be helpful authority. Twelve states have adopted the California Rule, in one form or another.³⁸ The section below examines when, according to the U.S. Supreme Court, statutes create a contract between the government and private parties, and reviews Court decisions holding that state laws created a contract.

33. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 21-26 (1977).

34. See, e.g., *Betts v. Bd. of Admin.*, 582 P.2d 614, 617 (Cal. 1978); *Singer v. City of Topeka*, 607 P.2d 467, 475-76 (Kan. 1980); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995).

35. See, e.g., *Klamm v. State ex rel. Carlson*, 126 N.E.2d 487, 489 (Ind. 1955); *State ex rel. Horvath v. State Teachers Ret. Bd.*, 697 N.E.2d 644, 654-55 (Ohio 1998).

36. *Dryden v. Bd. of Pension Comm'rs*, 59 P.2d 104, 106 (Cal. 1936).

37. *Allen v. City of Long Beach*, 287 P.2d 765 (Cal. 1955).

38. See *infra* Part II.F.

B. STATUTES AS CONTRACTS

1. In General

As noted above, most states have abandoned the gratuity approach to public pensions and have instead embraced some type of contractual protection for such benefits. In most cases, however, there is not an explicit contract between the state and its employees.³⁹ Rather, courts that have found a contract exists have inferred its existence, usually from the statute that creates such benefits and the surrounding circumstances.

A state law does not normally create contractual rights, but “merely declares a policy to be pursued until the legislature shall ordain otherwise.”⁴⁰ Legislation *can* create a contract, but courts require clear evidence of legislative intent prior to so holding.⁴¹ As the Supreme Court has explained, “to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body.”⁴² The party asserting that the statute created a contract has the burden of overcoming the presumption that the statute did not create a contract.⁴³ This presumption has been characterized as “no small hurdle to vault.”⁴⁴ In explaining the hesitancy to find that a statute creates a contract, the First Circuit Court of Appeals stated:

Finding a public contractual obligation has considerable effect. It means that a subsequent legislature is not free to significantly impair that obligation for merely rational reasons. Because of this constraint on subsequent legislatures, and thus on subsequent decisions by those who represent the public, there is, for the purposes of the Contract Clause, a higher burden to establish that a contractual obligation has been created.⁴⁵

39. That is, in most states the courts inferred a contract from the legislation establishing the retirement benefits. However, there may be cases in which a collective bargaining agreement (or “memorandum of understanding” as it is often called in the public employee context) creates an explicit contract with respect to retirement benefits.

40. *Nat’l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*, 470 U.S. 451, 465–66 (1985) (quoting *Dodge v. Bd. of Educ.*, 302 U.S. 74, 79 (1937)) (internal quotation marks omitted).

41. *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 17 n.14 (1977) (“In general, a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State.”).

42. *Nat’l R.R. Passenger*, 470 U.S. at 466.

43. *Dodge*, 302 U.S. at 78–79.

44. *Nat’l Educ. Ass’n–R.I. v. Ret. Bd. of the R.I. Emps.’ Ret. Sys.*, 890 F. Supp. 1143, 1151 (D.R.I. 1995).

45. *Parella v. Ret. Bd. of the R.I. Emps.’ Ret. Sys.*, 173 F.3d 46, 60 (1st Cir. 1999).

The starting point in determining if a statute creates a contract is to examine the statutory language.⁴⁶ However, even where the statute does not use explicit contractual language, “it is established that a legislative enactment may contain provisions which, when accepted as the basis of action by individuals, become contracts between them and the State or its subdivisions.”⁴⁷ In other words, even in the absence of explicit language regarding contract formation, statutory language may create a contractual offer that is accepted by performance.

Where there is no explicit language in the statute regarding the formation of a contract, courts look to the circumstances surrounding the law and its passage for evidence of legislative intent to bind itself contractually.⁴⁸ For example, a statute that explicitly reserves Congress’s right to amend, repeal, or alter that statute has been held to provide evidence that a legislature did not intend to bind itself by contract.⁴⁹ Similarly, frequent prior regulation of an area has also been considered evidence of a lack of intent to create a contract.⁵⁰ On the other hand, language that clearly expresses a covenant not to take certain actions now or in the future has been considered contractual in nature.⁵¹ The contours of Supreme Court precedent with respect to when statutory language creates a contract are examined in more detail below.

2. Supreme Court Cases Holding That State Law Creates a Contract

The U.S. Supreme Court has often struggled with cases asserting that a state law has created a contract that binds future legislatures. As the Supreme Court explained in 1877:

[T]he greatest trouble we have had on this point has been in regard to what may be called legislative contracts,—contracts found in statute laws of the State, if they existed at all. It has become the established law of this court that a legislative enactment, in the ordinary form of a statute, may contain provisions which, when accepted as the basis of action by individuals or corporations,

46. *Dodge*, 302 U.S. at 78–79 (noting also that state law requiring execution of a written contract should be considered contractual, as should state law confirming a “settlement of disputed rights” defining its terms).

47. *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938) (noting also that “[i]f the people’s representatives deem it in the public interest they may adopt a policy of contracting in respect of public business for a term longer than the life of the current session of the [l]egislature”).

48. *Nat’l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*, 470 U.S. 451, 470 (1985).

49. *Id.* at 467.

50. *Id.* at 468–69.

51. *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 17–18 (1977).

become contracts between them and the State within the protection of the clause referred to of the Federal Constitution.

The difficulty in this class of cases has always been to distinguish what is intended by the legislature to be an exercise of its ordinary legislative function in making laws, which, like other laws, are subject to its full control by future amendments and repeals, from what is intended to become a contract between the State and other parties when the terms of the statute have been accepted and acted upon by those parties.⁵²

In the end, the Court explained that determining when statutes create contracts requires “a critical examination of their terms, and of the circumstances under which they are created.”⁵³

Over the years, the U.S. Supreme Court has held with some regularity that state laws create contracts in two distinct situations: where the state has granted land to a third party and where the state has granted a specific tax exemption.⁵⁴ While the reasoning in these cases is at times hard to parse, the Court sometimes finds the existence of a contract based on explicit language (for example, that certain property will be exempt from tax “for ever”)⁵⁵ or because the parties have incurred expenses and acted in reliance on the state’s grant.⁵⁶

In many other situations, the Supreme Court has found the state’s obligation to be noncontractual. For example, in one case, despite a statutory promise that certain property would be exempt from taxation “forever,” the Court held that a general statute stating that the legislature had the power to amend and repeal statutes was enough to defeat the creation of a contract.⁵⁷ Also notable is a case that held that “an act merely fixing salaries of officers creates no contract in their favor and the compensation named may be altered at the will of the legislature. This is true also of an act fixing the term or tenure of a public officer or an

52. *New Jersey v. Yard*, 95 U.S. 104, 114 (1877).

53. *Id.*

54. See Robert L. Hale, *The Supreme Court and the Contract Clause: II*, 57 HARV. L. REV. 621 (1944) (providing an overview of the Supreme Court’s Contract Clause jurisprudence). For an example of a case where the Court found a contract because the state had granted a specific tax exemption, see *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812).

55. *Nw. Univ. v. People ex rel. Miller*, 99 U.S. 309 (1878). The U.S. Supreme Court has also found that a contract exists where the language is explicit, for example when two states “covenant and agree” with each other, by statute, to do and refrain from doing certain actions. *U.S. Trust Co. of N.Y.*, 431 U.S. at 18 (internal quotation marks omitted).

56. See, e.g., *Stearns v. Minnesota*, 179 U.S. 223, 231 (1900) (“The State, as trustee, held certain swamp and railroad lands. It proposed to give them to the company, subject to taxation in a certain way, if the company would construct the railroad. The company accepted the proposition and constructed the road. Thus, if the parties were competent to enter into such an arrangement, a contract was made.”).

57. *City of Covington v. Kentucky*, 173 U.S. 231 (1899).

employee of a state agency.”⁵⁸ Indeed, in considering whether an Illinois law providing for retirement benefits for public school teachers created a contract, the U.S. Supreme Court agreed with the Illinois Supreme Court that neither the language of the statute, nor the circumstances surrounding it, created a contract, despite the fact that the teachers argued that they had rendered services in reliance on the promised retirement benefits.⁵⁹ While *City of Covington v. Kentucky* and *Dodge v. Board of Education* each turned on its relevant facts, it is apparent from existing Supreme Court opinions that the Court requires clear evidence of legislative intent to form a contract before it will find that a contract exists. The next section considers the constitutional protection that applies once a court finds that a contract exists.

C. UNCONSTITUTIONAL IMPAIRMENT OF CONTRACTS

1. In General

The Contract Clause prohibits a state from passing a law that impairs existing contracts, whether public or private.⁶⁰ Specifically, Article I, section 10, clause 1 of the United States Constitution provides that “No State shall . . . pass any . . . Law impairing the Obligation of Contracts.”⁶¹ The Supreme Court has explained that

the word “contracts” in section 10 of article 1 of the Constitution is used in its usual or popular sense as signifying an agreement of two or more minds, upon sufficient consideration, to do or not to do certain acts. “Mutual assent . . . to its terms is of its very essence.”⁶²

Despite the fact that the language, on its face, appears to be absolute, it is well established that the prohibition against the impairment of contracts “must be accommodated to the inherent police power of the State ‘to safeguard the vital interests of its people.’”⁶³

Because most state constitutional contract clauses mirror the federal Constitution’s Contract Clause, the legal analysis is generally the same whether the state or federal constitutional clause is at issue.⁶⁴ Courts

58. *Dodge v. Bd. of Educ.*, 302 U.S. 74, 78–79 (1937) (footnotes omitted).

59. *Id.* at 79–80.

60. U.S. CONST. art. I, § 10, cl. 1; *U.S. Trust Co. of N.Y.*, 431 U.S. at 17.

61. U.S. CONST. art. I, § 10, cl. 1.

62. *Crane v. Hahlo*, 258 U.S. 142, 146 (1922) (quoting *Louisiana ex rel. Folsom v. Mayor of New Orleans*, 109 U.S. 285, 288 (1883)).

63. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 410 (1983) (quoting *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 434 (1934)).

64. *See, e.g.*, *City of Torrance v. Workers’ Comp. Appeals Bd.*, 650 P.2d 1162 (Cal. 1982); *Sonoma Cnty. Org. of Pub. Emps. v. Cnty. of Sonoma*, 591 P.2d 1 (Cal. 1979); *Felt v. Bd. of Trs. of the Judges Ret. Sys.*, 481 N.E.2d 698, 701 (Ill. 1985); *see also* 16B Am. Jur. 2d *Constitutional Law* § 753 (2012) (“Generally, the federal and state constitutional guarantees against the

undertake a three-part analysis to determine whether state actions that potentially affect contracts are unconstitutional under the Contract Clause.⁶⁵ The first step is to determine whether a contractual relationship exists.⁶⁶ Where the statute at issue is ambiguous, the court looks to whether “the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State.”⁶⁷ The second step in a contract clause analysis is to determine whether the state action constitutes a substantial impairment of a contractual relationship.⁶⁸ An impairment occurs if it alters the contractual relationship between the parties⁶⁹ and is substantial—for example, “where the right abridged was one that induced the parties to contract in the first place, or where the impaired right was one on which there had been reasonable and especial reliance.”⁷⁰ The Supreme Court has stated that a substantial impairment can occur even though the contract is not completely destroyed.⁷¹ However, the Supreme Court has also held that state regulation restricting a party to gains it reasonably expected from the contract is not necessarily a substantial impairment.⁷²

Finally, if a substantial impairment is found, a court may nevertheless find the change to the relevant contract constitutional if it is justified by an important public purpose and if the action undertaken to advance the public interest is “reasonable and necessary.”⁷³ In determining whether the action is aimed at an important public purpose, courts look to see whether there is a “significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem.”⁷⁴ Doing this ensures that the state is actually acting under its

impairment of contractual obligations are interpreted essentially identically and given the same effect.”).

65. See *U.S. Trust Co. of N.Y.*, 431 U.S. at 17–25.

66. See *id.* at 17–18.

67. *Id.* at 17 n.14.

68. See *id.* at 21–23.

69. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 240 (1978).

70. *Balt. Teachers’ Union v. Mayor & City Council of Balt.*, 6 F.3d 1012, 1017 (4th Cir. 1993) (citations omitted). The Supreme Court has said relatively little about the “substantial” standard. In *Spannaus* it explained:

The severity of an impairment of contractual obligations can be measured by the factors that reflect the high value the Framers placed on the protection of private contracts. Contracts enable individuals to order their personal and business affairs according to their particular needs and interests. Once arranged, those rights and obligations are binding under the law, and the parties are entitled to rely on them.

Spannaus, 438 U.S. at 245.

71. *U.S. Trust Co. of N.Y.*, 431 U.S. at 26–27.

72. *Id.* at 31 (citing *El Paso v. Simmons*, 379 U.S. 497, 515 (1965)).

73. *Id.* at 25.

74. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411–12 (1983) (citations omitted). Earlier Supreme Court opinions had noted that relevant factors in

police power and not “providing a benefit to special interests.”⁷⁵ Where a state seeks to impair a contract to which it is a party, a reviewing court does not completely defer to the state legislature’s determination of what is reasonable or necessary in the circumstances.⁷⁶ In determining reasonableness, courts consider whether the circumstances that necessitated the change “were unforeseen and unintended by the legislature” when the contract was formed.⁷⁷ In addition, in determining reasonableness the court takes into account the degree of impairment.⁷⁸ The state’s action is considered to be necessary when (1) no other, less drastic modification could have been implemented, and (2) the state could not have achieved its goals without the modification.⁷⁹

2. As Applied to Prospective Changes

Given this Article’s focus on prospective pension changes, it is important to note that there is authority for the position that under a contract clause analysis, prospective changes should not be considered significant contractual impairments. For example, one federal court stated that “[t]he Contract Clause does not prohibit legislation that operates prospectively,” citing *U.S. Trust* as authority.⁸⁰ My research did, however, identify a single federal decision that found a prospective change to a fixed-duration contract to be a substantial impairment.⁸¹ But the more common approach appears to be that prospective changes to contracts, although properly considered impairments, should not be considered substantial and are therefore constitutional.⁸² The Subpart below reviews the status of

determining whether a modification was a permissible exercise of the police power included whether there existed an emergency justifying the modification, whether the relief was “appropriately tailored to the emergency,” and whether the legislation was “limited to the duration of the emergency.” *Spannaus*, 438 U.S. at 242. Later Supreme Court decisions excluded the emergency-related factors. See *Energy Reserves Grp.*, 459 U.S. at 412 (“[S]ince *Blaisdell*, the Court has indicated that the public purpose need not be addressed to an emergency or temporary situation.”).

75. *Energy Reserves Grp.*, 459 U.S. at 412.

76. *Id.* at 412–13 (citing *U.S. Trust Co. of N.Y.*, 431 U.S. at 22–23).

77. *U.S. Trust Co. of N.Y.*, 431 U.S. at 31.

78. *Id.* at 27.

79. *Id.* at 29–30.

80. *Robertson v. Kulongoski*, 359 F. Supp. 2d 1094, 1100 (D. Or. 2004). The court further explained that “[i]f the State of Oregon is to be bound to provide employees a set level of benefits in perpetuity, such a legislative intent must be clear. Here it is not.” *Id.*

81. See *Ass’n of Surrogates & Supreme Court Reporters v. New York*, 940 F.2d 766 (2d Cir. 1991) (holding that a prospective lag in payroll, which delayed the payment of ten days’ wages until an employee’s termination, was a significant impairment of contract).

82. See, e.g., *Buffalo Teachers Fed’n v. Tobe*, 464 F.3d 362 (2d Cir. 2006) (holding that a prospective and temporary wage freeze was not a substantial impairment of a contract); *Local Div. 589, Amalgamated Transit Union, AFL–CIO v. Massachusetts*, 666 F.2d 618, 637 (1st Cir. 1981) (finding the Contract Clause applicable only to laws with retroactive effect); *Md. State*

pensions as a form of deferred compensation, and the legal implications that stem from that status.

D. PENSIONS AS DEFERRED COMPENSATION

The U.S. Supreme Court has held that public employees have a contractual right, protected by the federal Constitution, to compensation that has been earned through services rendered.⁸³ This right is not based on statutory language, but rather is implied from the fact that the employee performed services in exchange for the promised compensation.⁸⁴ It only extends, however, to compensation earned, and thus “does not limit the power of a state . . . to pass and give effect to laws prescribing . . . the salaries or other compensation to be paid” to public employees.⁸⁵

Pension benefits are, at their core, a form of deferred compensation.⁸⁶ They are given in return for an employee’s labor and they are structured in the form of pension benefits, rather than current cash wages, for at least two distinct reasons. First, such benefits, accrued over a long period of time, can incentivize employees to stay with a given employer for longer than they might otherwise choose in the absence of such benefits.⁸⁷ Second, pension benefits can also be structured in a way that encourages employees to voluntarily leave their employment at the time desired by their employers, thus improving human resource efficiency.⁸⁸

Pension benefits also likely have paternalistic motivations. If an employer is concerned that its employees will not adequately save for retirement on their own or will make poor decisions regarding issues such as savings level, investment options, and the rate of withdrawals, then providing a traditional pension plan removes nearly all such decisions from an employee’s control and provides employees with a known benefit amount at retirement for as long as the employee lives.⁸⁹

Of course, basic economic theory suggests that the employer will only offer such benefits if the benefits are, in fact, desired and valued by the workers the employer wishes to attract and retain. If the desired employees did not value pension benefits, the employer would be better off offering an

Teachers Ass’n, Inc. v. Hughes, 594 F. Supp. 1353, 1360 (D. Md. 1984) (finding retroactive effect a prerequisite to a successful Contract Clause challenge).

83. Mississippi *ex rel.* Robertson v. Miller, 276 U.S. 174, 178–79 (1928).

84. *See id.*

85. *Id.*

86. *See, e.g.,* People *ex rel.* Kroner v. Abbott, 113 N.E. 696, 698 (Ill. 1916).

87. For an overview of the incentive effects of pension plans in the education context, see Robert M. Costrell & Michael Podgursky, *Distribution of Benefits in Teacher Retirement Systems and Their Implications for Mobility*, 5 EDUC. FIN. & POL’Y 519 (2010).

88. *See id.*

89. Amy B. Monahan, *Addressing the Problem of Impatients, Impulsives and Other Imperfect Actors in 401(k) Plans*, 23 VA. TAX REV. 471, 478–79 (2004).

equivalent amount of current cash compensation.⁹⁰ After all, it is important to remember that these issues are contained within the basic employer–employee framework. At the most basic level, an employer offers these benefits in order to compete for and retain valued employees, in return for the employees’ labor.⁹¹ These benefits are part of the overall compensation package, but are structured differently than current cash compensation in order to provide desired benefits to both employer and employee.

While the compensatory nature of pension benefits is well acknowledged, it is important to note that such benefits are often structured such that if the conditions set forth in the plan are not met, the benefits may be forfeited even after they are *earned* through service performed for an employer. For example, a plan might require that an employee work for the employer for five years before she will be entitled to any pension benefit. Thus, although the employee might have earned a pension benefit equal to \$3000 after three years of working for her employer, if she quits her job at that point she will forfeit the entire amount of that deferred compensation. These types of “vesting” requirements are regulated at the federal level⁹² and are an acknowledged, permissible feature of pension plans.⁹³ In that sense, in addition to being deferred compensation, prior to vesting, pension benefits are also contingent compensation.

Because pension benefits are a form of compensation, it is logical to extend the U.S. Supreme Court holding that compensation earned by public employees is entitled to implied contractual protection to provide that earned pension benefits are similarly protected.⁹⁴ Protecting earned compensation, regardless of whether it is currently paid or deferred until a later date, is noncontroversial and does not depend on contractual statutory language. As will be discussed below, California state courts have gone beyond this noncontroversial position to hold that future pension accruals are also entitled to protection, despite the fact that future salary levels are not. Before discussing such state law developments, the Subpart below will

90. This assumes, of course, that the incentive and behavioral effects of the pension plan enjoyed by the employer as a result of offering the plan do not outweigh the employee’s preference for cash compensation.

91. See, e.g., William K. Carr & Robert L. Liebross, *Wrongs Without Rights: The Need for a Strong Federal Common Law of ERISA*, 4 STAN. L. & POL’Y REV. 221, 225–26 (1993) (“Employee benefits are simply wages in different form and valued in different ways. The benefit is not donated out of the goodness of the employer’s heart. Whether the benefit is a pension, health insurance coverage, or severance pay, it is offered as a conditional or unconditional promise in exchange for a person’s labor.”).

92. See I.R.C. § 411(a) (2006) (establishing general vesting requirements); *id.* § 411(e) (establishing vesting requirements for governmental plans). Vesting is also regulated by ERISA, but governmental plans are exempt from ERISA’s requirements. See 29 U.S.C. § 1003(b) (2006).

93. See *supra* note 92.

94. See *Mississippi ex rel. Robertson v. Miller*, 276 U.S. 174, 179 (1928).

examine how federal courts have examined claims that state statutes creating public employee retirement systems create contracts between the state and its employees.

E. FEDERAL COURTS ON PUBLIC EMPLOYEE PENSION STATUTES AS CONTRACTS

In many states, both the state and federal constitutions prohibit a state from impairing contractual obligations. As a result, pension plan participants facing a detrimental change in benefits often can choose between making either a state or federal constitutional claim and then filing in the relevant court. In states without a constitutional contract clause, resort to a federal Contract Clause claim may be the only option. As a result, federal courts have had the opportunity to consider the circumstances under which state statutes establishing pension benefits should be interpreted to create a contract.

In reviewing federal constitutional challenges, the federal courts have clarified that “[a]lthough federal courts look to state law to determine the existence of a contract, federal rather than state law controls as to whether state or local statutes or ordinances create contractual rights protected by the Contracts Clause.”⁹⁵ Nevertheless, federal courts do “give great weight to the views of the highest court of the State” on whether a contract exists.⁹⁶ And, as previously discussed, “[u]nder federal law the state’s statutory language must evince a clear and unmistakable indication that the legislature intends to bind itself contractually before a state legislative enactment may be deemed a contract for purposes of the Contracts Clause.”⁹⁷ My research, however, identified no federal cases where a federal court ruled in direct opposition to a state court’s finding that a contract existed under federal law.

F. RIGHTS TO FEDERALLY CREATED PUBLIC RETIREMENT BENEFITS

While this Article focuses on legal rights to statutorily created retirement benefits for state and local employees, it is instructive to review the legal protection for federal Social Security benefits, particularly given that for some employees, state and local plans are a substitute for such benefits. It is clear, as a matter of federal law, that Social Security benefits are noncontractual in nature.⁹⁸ Rather, the Supreme Court has held that

95. *San Diego Police Officers’ Ass’n v. San Diego City Emps.’ Ret. Sys.*, 568 F.3d 725, 737 (9th Cir. 2009).

96. *Dodge v. Bd. of Educ.*, 302 U.S. 74, 79 (1937); *see also San Diego Police Officers’ Ass’n*, 568 F.3d at 737.

97. *San Diego Police Officers’ Ass’n*, 568 F.3d at 737 (citations omitted). The court noted that it is legislative intent, not the importance of the benefits to individuals, that is the key to contract formation. *Id.* at 740.

98. *Richardson v. Belcher*, 404 U.S. 78, 80 (1971) (“[A]n expectation of public benefits [does not] confer a contractual right to receive the expected amounts.”); *Flemming v. Nestor*,

federal benefits statutes, such as the Social Security Act, create a property interest that is protected by the Fifth Amendment.⁹⁹ As a result, potential Social Security recipients are entitled to procedural due process and are protected only against arbitrary government action “utterly lacking in rational justification.”¹⁰⁰ Therefore, even “earned” Social Security benefits can be reduced or revoked if such changes have a rational basis.

G. SUMMARY OF THE FEDERAL APPROACH

Under federal law, state laws are presumed to be noncontractual absent clear and unambiguous evidence that the legislature intended to bind itself. If a contract is found to exist, the state may impair it only when reasonable and necessary to serve an important public purpose. Although the U.S. Supreme Court has acknowledged that public employees have a contractual right to the payment of salary earned by performing services in exchange for a promised salary, the Court has never held that a pension statute creates a contract. Additionally, authority exists at the federal level for the position that prospective changes to contracts should not be considered substantial impairments of the contract. Part II below traces the development of the California Rule, which deviates in multiple ways from the federal standard outlined above.

II. THE CALIFORNIA RULE

Current California law holds that pension statutes not only create a contract between the state and its employees but also that the contract is formed as of the first day of employment and is of open duration, thereby protecting both past and future pension accruals.¹⁰¹ Given the legal presumption that legislation does not create a contract absent explicit evidence of intent to do so, the position of the California courts is difficult to explain, because the holdings of the relevant California cases do not point to any such explicit evidence of intent. This Part traces the development of the California Rule in order to better understand these holdings, which are inconsistent with long-standing jurisprudence regarding statutes as contracts. This Part demonstrates how the law in this area is unsupported by relevant authority. First, the notion of pension rights as contractual rights became law through a single sentence of dicta in a California Supreme Court opinion describing pensions as a form of deferred compensation that are therefore “in a sense” part of the contract of employment. From there, later courts built upon this base to hold that (1)

363 U.S. 603, 610 (1960) (referring to the right to Social Security benefits as “noncontractual”).

99. *Mathews v. Eldridge*, 424 U.S. 319, 332 (1976).

100. *Flemming*, 363 U.S. at 611.

101. See generally *Legislature v. Eu*, 816 P.2d 1309 (Cal. 1991); *Allen v. City of Long Beach*, 287 P.2d 765 (Cal. 1955).

the contract is formed and vests as of the first day of employment; (2) any detrimental changes must be offset by comparable new advantages; and (3) the contract protects not only what an employee has earned but also what she might possibly earn in the future—all without attempting to justify these positions through an examination of the relevant statutory language or the circumstances surrounding its passage. To begin, the first Subpart examines the California courts' general approach to determining whether a statute creates contractual rights.

A. CALIFORNIA'S GENERAL APPROACH TO STATUTES AS CONTRACTS

Before examining the approach of California courts to public pension rights, it is instructive to examine other, nonpension cases in which California courts have found an implied contract on the basis of a state statute. California courts have acknowledged that “[c]ontracts may be made or evidenced by a statute, and by conduct ensuing thereupon, as well as by other means of evidence.”¹⁰² California courts have, in general, stated that “legislative intent to grant contractual rights can be implied from a statute if it contains an unambiguous element of exchange of consideration by a private party for consideration offered by the state.”¹⁰³ In a nonpension benefit case, a court even explained that pension benefits are contractual because a “statute offering pension rights in return for employee services expresses an element of exchange and thereby implies these rights will be private rights in the nature of contract.”¹⁰⁴ As a general matter, California courts have agreed that a “statute fixing government payments may amount to an offer which, when accepted by performance, culminates in a contract between the government and the offeree.”¹⁰⁵ In other words, if a law sets out conditions for state payment, and an individual complies with those conditions, “all the elements which are necessary to the formation and existence of an implied contract” are present.¹⁰⁶ Not surprisingly, California courts have clarified that the current legislature’s opinion regarding whether a prior legislative enactment created a contract is not controlling.¹⁰⁷

In *California Teachers Ass’n v. Cory*, a California court of appeals found that a statute setting out precise dollar amounts that must be contributed by

102. *San Luis Obispo Cnty. v. Gage*, 73 P. 174, 177 (Cal. 1903); *see also* *Cal. Teachers Ass’n v. Cory*, 202 Cal. Rptr. 611, 620 (Ct. App. 1984).

103. *Cal. Teachers Ass’n*, 202 Cal. Rptr. at 617.

104. *Id.* at 618.

105. *Cal. Med. Ass’n v. Lackner*, 172 Cal. Rptr. 815, 821 (Ct. App. 1981) (quoting *Cal. Ass’n of Nursing Homes, Sanitariums, Rest Homes & Homes for the Aged, Inc. v. Williams*, 84 Cal. Rptr. 590, 602 (Ct. App. 1970)) (internal quotation marks omitted). In *San Luis Obispo County*, the court analogized to “the case where a natural person offers a reward for the performance of some particular act, as the recovery of property or the apprehension of a criminal.” *Gage*, 73 P. at 178.

106. *Gage*, 73 P. at 178.

107. *Cal. Teachers Ass’n*, 202 Cal. Rptr. at 618.

the state to the Teachers' Retirement Fund over a period of fifteen years created a contract that was protected against impairment.¹⁰⁸ The court focused on the fact that the language of the statute showed a "continuing obligation to fund the Teachers' Retirement Fund in specific amounts in future years."¹⁰⁹ The court then made the connection between plan funding and benefit security and stated that the "promise of funding" was made in exchange "for the valuable services rendered by the state's teachers."¹¹⁰ The court went on to state that the statute illustrated "an unambiguous commitment to permanent, long-term financing,"¹¹¹ and that the statute was "a straight-out promise to pay fixed and determinable sums of money."¹¹² The court found that the inference of a contract arose from the fact that: (1) future funding installments were provided for in present appropriations; and (2) a teacher who had accepted employment with the knowledge of this funding obligation would gain nothing from it if the funding obligation were subject to legislative modification.¹¹³ The court further found that because underfunding would potentially affect *all* pension benefits, not just those from a specific time, the state's promise could not be "divisible into *pro tanto* segments."¹¹⁴

In *Valdes v. Cory*, an appellate court examined whether the state could permissibly redirect employer contributions from the public employees' retirement system to the state's general fund.¹¹⁵ The court found that such actions impermissibly impaired the contract between employees and their state employers.¹¹⁶ In reaching its decision, the court went through a standard contract clause analysis by first determining whether a contract existed.¹¹⁷ The court began its analysis by examining the legislative history as well as the current provisions of the retirement law, explaining that it was looking for clear evidence of legislative intent to create private contractual rights.¹¹⁸ While the statute itself did not use explicit contractual terms, the court found that the language referring to the funding obligation as a "continuing obligation[] of the State" and other provisions that provided

108. *Id.* at 619–23.

109. *Id.* at 618.

110. *Id.*

111. *Id.*

112. *Id.* at 620.

113. *Id.* at 620–21.

114. *Id.* at 621.

115. *Valdes v. Cory*, 189 Cal. Rptr. 212 (Ct. App. 1983).

116. *Id.* at 223.

117. *Id.* at 222–23.

118. *Id.* The court interpreted the contract to provide that employer contributions to the retirement system would be changed only on the basis of actuarial funding needs. *Id.*

modification of contribution rates only on the basis of actuarial projections manifested a legislative intent to create a contract.¹¹⁹

In another case, a California court found that the employees had a contractual right to retiree health benefits where (1) the individuals had retired while ordinances and policies were in place granting such benefits; and (2) the individuals served as state officers, whose compensation could not be reduced during their term of office under the California constitution.¹²⁰ Other cases, however, have declined to find a contractual right to specific retiree health benefits.¹²¹ Recently, the California Supreme Court ruled that it was possible for county employees to establish an implied contractual right to retiree health benefits from a county ordinance or resolution.¹²²

Other examples of statutes that have been held to create contracts include “[r]ules and regulations adopted by a board of education,” which become part of a teacher’s employment contract,¹²³ statutory rates of compensation paid to providers under the state’s Medicaid program,¹²⁴ and a statute granting local governments fixed-dollar-amount support in return for programs caring for orphaned and abandoned children.¹²⁵ Under California law, therefore, a statute can create a contract in accordance with its express terms, by implication of its express terms, or where the statute essentially constitutes an offer that is accepted by performance. In those cases where the contract was created by performing services in exchange for a promise, it is important to note that the court interpreted the contract to provide only the promised compensation for the services performed. In none of the cases identified did the contract entitle the individual to that same rate of compensation for future services. California courts are in this manner consistent with federal Contract Clause jurisprudence. Before examining California’s pension rulings, the following Subpart examines the

119. *Id.* at 223 (internal quotation marks omitted).

120. *Thorning v. Hollister Sch. Dist.*, 15 Cal. Rptr. 2d 91, 97 (Ct. App. 1992).

121. *See, e.g.*, *Sappington v. Orange Unified Sch. Dist.*, 14 Cal. Rptr. 3d 764, 768 (Ct. App. 2004); *Orange Cnty. Emps. Ass’n v. Cnty. of Orange*, 285 Cal. Rptr. 799, 806 (Ct. App. 1991); *Ventura Cnty. Retired Emps.’ Ass’n v. Cnty. of Ventura*, 279 Cal. Rptr. 676, 678 (Ct. App. 1991). It is important to note, however, that most retiree-health-benefits cases occur in the collective-bargaining context, where there is an *actual* contract to interpret.

122. *Retired Emps. Ass’n of Orange Cnty., Inc. v. Cnty. of Orange*, No. S184059, 2011 WL 5829598, at *14 (Cal. Nov. 21, 2011).

123. *Am. Fed’n of Teachers v. Oakland Unified Sch. Dist.*, 59 Cal. Rptr. 85, 89 (Ct. App. 1967).

124. *Cal. Med. Ass’n v. Lackner*, 172 Cal. Rptr. 815, 821 (Ct. App. 1981).

125. *San Luis Obispo Cnty. v. Gage*, 73 P. 174, 178 (Cal. 1903). In finding that a statute granting funds to local governments for the care of orphaned and abandoned children created a contract, the California Supreme Court explained that the statute was “the equivalent of an offer upon condition, and upon the performance of the condition by any county the offer became a promise, and binding as such upon the state.” *Id.*

broader context of these rulings by providing a brief overview of California laws governing public employment and compensation rights.

B. PUBLIC EMPLOYMENT AND COMPENSATION RIGHTS IN CALIFORNIA

As a general rule, under California law, the terms and conditions of public employment are controlled by “statute or ordinance rather than by . . . contract.”¹²⁶ Nevertheless, the California Supreme Court has cited with approval the U.S. Supreme Court holding that public employee compensation that has been earned through services rendered is entitled to contractual protection.¹²⁷ As the California Supreme Court has explained, with respect to “certain terms or conditions of employment that are created by statute, an employee who performs services while such a statutory provision is in effect obtains a right, protected by the contract clause, to require the public employer to comply with the prescribed condition.”¹²⁸ Promised compensation is one such right.¹²⁹ While compensation that has been earned through services rendered is protected, the California Supreme Court has held that *prospective* decreases in public employee salaries are permissible.¹³⁰

With respect to nonsalary benefits, California courts have been slightly less consistent. One appellate court held that “whenever benefits or conditions of employment are important to the employees, they acquire protection under the contract clause.”¹³¹ Relying on a case addressing when an individual has a fundamental vested right for purposes of due process rights, the court stated that to determine which benefits are entitled to such protection, the court must evaluate “the effect of [the benefit] in human

126. *Cal. League of City Emp. Ass'ns v. Palos Verdes Library Dist.*, 150 Cal. Rptr. 739, 741 (Ct. App. 1978). While public employees who have achieved “permanent” employment status have a vested property interest in that employment, which is protected by the Due Process Clause of the Constitution, this entitles the employee only to procedural protection, such as the right to notice and hearing. It does not, however, prevent the state from taking adverse action after it has complied with the procedural requirements. *See, e.g., Coleman v. Dep't of Pers. Admin.*, 805 P.2d 300, 308–12 (Cal. 1991).

127. *Terry v. City of Berkeley*, 263 P.2d 833, 836 (Cal. 1953) (citing *Mississippi ex rel. Robertson v. Miller*, 276 U.S. 174 (1928)).

128. *White v. Davis*, 68 P.3d 74, 98 (Cal. 2003) (emphasis omitted).

129. *Id.* at 99. Of course, compensation rights provided by a memorandum of understanding (which is the equivalent of a collective bargaining agreement for public employees) are protected by an actual contract, and as a result, the right to a stated level of compensation may be protected for the entire term of the agreement, such that future compensation cannot be reduced during the term of such agreement. *See, e.g., Sonoma Cnty. Org. of Pub. Emps. v. Cnty. of Sonoma*, 591 P.2d 1, 4–5 (Cal. 1979).

130. *Prof'l Eng'rs in Cal. Gov't v. Schwarzenegger*, 239 P.3d 1186, 1190–91 (Cal. 2010).

131. *San Bernardino Pub. Emps. Ass'n v. City of Fontana*, 79 Cal. Rptr. 2d 634, 638 (Ct. App. 1998) (discussing *Cal. League of City Emp. Ass'ns*, 150 Cal. Rptr. at 741–42).

terms and the importance of it to the individual in the life situation.”¹³² Other appellate courts have disagreed with this line of reasoning, stating that it is contrary to the long-standing rule that “public employees have no vested right in any particular measure of compensation or benefits, and that these may be modified or reduced by the proper statutory authority.”¹³³ The California Supreme Court seems to favor the latter interpretation.¹³⁴

It is clear that in California a public employee has a right to the salary she has earned, and protecting earned pension benefits is a logical extension of this general proposition. With respect to public employee salary rights, California is entirely consistent with federal jurisprudence on the subject. But as the Subpart below demonstrates, California courts have gone far beyond this principle in protecting pension benefits, and have granted such benefits greater protections than those afforded to cash compensation.

C. THE EVOLUTION OF CALIFORNIA’S PUBLIC PENSION JURISPRUDENCE

1. Early Cases

When California first considered the scope of the legal rights associated with public employee pensions in 1889, it was in the context of a claim by a widow for a death benefit related to her husband’s service as a police officer.¹³⁵ In that case, the police officer worked under a law that provided for a death benefit; however, after the start of his employment, but before his death, that law was amended to eliminate the benefit.¹³⁶ In denying the widow the originally promised benefit, the court stated that the legal interest involved was only an expectancy, not a property right.¹³⁷ The opinion went on to state that “[a] public officer—at least one whose term and compensation are not prescribed by the constitution—has no contract by which he can have or hold either his office or his salary against the legislative will.”¹³⁸ The U.S. Supreme Court upheld the ruling, stating that the law at issue “was subject to change or revocation at any time, at the will of the legislature. There was no contract on the part of the State . . .”¹³⁹ This approach, known as the “gratuity” approach, essentially allows the

132. *Cal. League of City Emp. Ass’ns*, 150 Cal. Rptr. at 741–42 (quoting *Bixby v. Pierno*, 481 P.2d 242, 252 (Cal. 1971)) (internal quotation marks omitted).

133. *San Bernardino Pub. Emps. Ass’n*, 79 Cal. Rptr. 2d at 639 (citing *Butterworth v. Boyd*, 82 P.2d 434, 439 (Cal. 1938)).

134. *See, e.g., White*, 68 P.3d at 86; *Butterworth*, 82 P.2d at 439.

135. *Pennie v. Reis*, 22 P. 176 (Cal. 1889).

136. *Id.* at 177.

137. *Id.*

138. *Id.*

139. *Pennie v. Reis*, 132 U.S. 464, 471 (1889).

legislature to make changes to public employee pension benefits as it sees fit.¹⁴⁰

California began to depart from the standard position that pensions are gratuities in 1917 when the California Supreme Court decided the case of *O'Dea v. Cook*.¹⁴¹ The *O'Dea* case concerned a police officer who was injured in 1912, but who did not die of those injuries until 1915.¹⁴² At the time of his injury, the relevant law provided that the police officer's widow would be entitled to a pension if the officer died as a result of injuries sustained on the job.¹⁴³ In 1914, after the police officer was injured but before his death, the law was amended to provide that a widow's pension would only be payable if the officer's death occurred within one year from the date of injury.¹⁴⁴ In considering whether the law as amended could be applied to the widow in this case, the court stated that "[a] pension such as this law contemplates is not a gratuity or a gift."¹⁴⁵ To support that statement, the court noted that if it were a gift, it would violate California's constitution, which prohibits the state from providing gifts to individuals.¹⁴⁶ Instead, the court explained that a pension is a gift only if it is granted *after* the services have been rendered.¹⁴⁷ Because California courts had previously held that pensions were gratuities, the court cited cases from Nebraska and New York as authority for the proposition that pensions are not gratuities.¹⁴⁸

The court did not, however, find that the statute at issue created a contract, but rather it found that the widow of an injured police officer had no right to the death benefit pension until and unless the officer died as a result of those injuries.¹⁴⁹ In other words, it was only once all of the conditions of the unamended law had been met that she had a right to the pension. The court also stated, in dictum, "where, as here, services are rendered under such a pension statute, the pension provisions become a part of the contemplated compensation for those services and so *in a sense* a part of the contract of employment itself."¹⁵⁰ To support this statement regarding the nature of pension rights, the court cited cases from Nebraska, New York, and Illinois.¹⁵¹ The trouble is, the cases cited only support the

140. See, e.g., Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994 (1977).

141. *O'Dea v. Cook*, 169 P. 366 (Cal. 1917).

142. *Id.* at 366.

143. *Id.* at 366-67.

144. *Id.* at 367.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* (emphasis added).

151. *Id.*

proposition that pensions are a form of compensation for services rendered, and none of the cases cited use any type of “contract” language.¹⁵² Thus, *O’Dea* is the first case to suggest that pension statutes might create contracts; however, the court developed this idea without authority for the position and without an examination of legislative intent. But at this point, the court’s language is not itself problematic. Stating that pension benefits are part of the promised compensation for services is consistent with the theory that pensions are merely deferred compensation, and thus are entitled to the same protection as promised salary. Characterizing pensions as a form of compensation would not, for example, appear to prevent prospective changes to pension benefits. Moreover, the language itself is not very strong. Note that the court did not directly state that a contract is created, but rather that pensions, as a form of compensation, become “in a sense” a part of the general contract of employment—a position that is consistent with rulings regarding the payment of salary to an employee. The idea is that just as an employee is entitled to receive the salary she was promised in return for performing work, the court’s language in *O’Dea* can be read to simply suggest that, like salary, pension benefits earned through service must be paid.

The out-of-state cases cited by the court support the above interpretation, as they each characterized pensions not as contractual, but rather as a form of deferred compensation.¹⁵³ As the Illinois Supreme Court explained, pensions “are in the nature of compensation for services previously rendered for which full and adequate compensation was not received at the time of the rendition of the services. It is, in effect, pay withheld to induce long-continued and faithful service.”¹⁵⁴ It seems very likely the *O’Dea* court was not using “contract” in its formal sense, especially given that at the time the case was decided it was clear that public employment itself did not create a contract.¹⁵⁵

However, in the 1936 decision *Dryden v. Board of Pension Commissioners of Los Angeles*,¹⁵⁶ a state appellate court, in a single sentence of dicta, gave new meaning to *O’Dea*’s statement about the legal right to pension benefits. The issue in *Dryden* was whether a widow who filed a claim for a pension after the six-month period proscribed by the relevant statute could be denied her entire pension or only the pension payments due prior to the date of the claim.¹⁵⁷ The court easily concluded that failing to file within six months did

152. See *infra* notes 154–55 and accompanying text.

153. See *People ex rel. Kroner v. Abbott*, 113 N.E. 696, 698 (Ill. 1916); *State v. Love*, 131 N.W. 196, 199 (Neb. 1911); *Hammit v. Gaynor*, 144 N.Y.S. 123, 126 (Sup. Ct. Special Term 1913).

154. *Kroner*, 113 N.E. at 698.

155. See *Pennie v. Reis*, 22 P. 176, 177 (Cal. 1889).

156. *Dryden v. Bd. of Pension Comm’rs*, 51 P.2d 177 (Cal. Dist. Ct. App. 1935).

157. *Id.* at 177–78.

not defeat the widow's entire right to a pension, but only her right to past payments.¹⁵⁸ In dictum, however, the court noted that pension provisions "are an indispensable part of [the] contract [of employment], and that the right to a pension *becomes a vested one upon acceptance of employment by an applicant.*"¹⁵⁹ The court cited *O'Dea, Aitken v. Roche*,¹⁶⁰ and *French v. Cook*¹⁶¹ for this proposition, even though these authorities do not support it. *O'Dea*, as just discussed, held that an individual has a vested right to pension only after satisfying all of the contingencies applicable to such a benefit.¹⁶² *Aitken* focused on the correct interpretation of a pension statute, but the court noted in a statement not required for its holding that "the right to pension is a vested one, and that it enters into the contract of employment when a man enters the police department."¹⁶³ Finally, *French v. Cook* dealt with the authority of a city pension board and contained no statements lending support to the language in *Dryden* that pension rights vest upon commencement of employment.¹⁶⁴ Indeed, the court noted, "It has been held under very similar circumstances that the widow has a vested right from the date of death of her husband."¹⁶⁵

While the dictum in *Dryden*, a court of appeals decision, would have been unlikely to have any lasting effect in this area, the California Supreme Court gave this statement weight when, on appeal, it merely adopted the language of the appellate court as its own, rather than issuing a new opinion.¹⁶⁶ As a result, that unfortunate bit of dictum ended up becoming the dictum of the California Supreme Court, which profoundly impacted the future development of the law in this area.

The statement itself is worth examining in more detail. The new language here provides that the right to a pension is contractual and *vests on the first day of employment*. Perhaps the statement is not too surprising. After all, if one read the language of *O'Dea*—that pensions are part of the "contract of employment"—literally, it may be reasonable to assume that the contract forms on the first day of work. But to also hold that the right to a pension vests on the first day of employment is more unexpected. First, it is somewhat odd to talk about a vested right to a pension on the first day of

158. *Id.* at 179–80.

159. *Id.* at 178 (emphasis added).

160. *Aitken v. Roche*, 192 P. 464 (Cal. App. 1920).

161. *French v. Cook*, 160 P. 411 (Cal. 1916).

162. *O'Dea v. Cook*, 169 P. 366, 367 ("True, she could secure no widow's pension at all, unless the death occurred under the circumstances contemplated by the statute . . .").

163. *Aitken*, 192 P. at 464 (citing *O'Dea*, 163 P. 366). This statement mischaracterizes *O'Dea*, which held that there was no right to a pension until all relevant contingencies had been met. See *O'Dea*, 169 P. 366 at 367.

164. See *French*, 160 P. 411.

165. *Id.* at 413.

166. *Dryden v. Bd. of Pension Comm'rs*, 59 P.2d 104, 105 (Cal. 1936).

employment, given that pensions accrue over time and are by their very terms forfeitable until the employee meets the various age and service requirements of the pension.¹⁶⁷ Perhaps all the court was trying to say is that, like salary, pension benefits earned, beginning on the first day of employment, must be paid. If this is the correct interpretation, it comports with a theory of pensions as a form of deferred compensation: once services have been rendered in exchange for promised compensation, whether due currently or deferred, the state's obligation to pay is absolute. If, instead, *Dryden* is interpreted to provide contractual rights beyond the protection of earned benefits, it would represent a significant departure from established jurisprudence. Regardless, the failure of the court to discuss the meaning of the statement, or the court's basis for it, lead to uncertainty with respect to how future pension changes would be analyzed by California courts.

Later California courts tried to soften *Dryden*'s impact. For example, in a 1938 court of appeals case, the court stated that while the right to a pension is a vested right, "it is only the right to a pension, reasonable in amount, in accordance with the circumstances and the time that the pension becomes operative by the retirement of the employee."¹⁶⁸ The court went on to say that although the right may be a vested right, "the amount of the pension may not always be ascertained until the last contingency has occurred."¹⁶⁹ While some courts tried to reconcile the statement in *Dryden* with earlier rulings stating that one is not entitled to a pension until all contingencies have been met, other courts openly criticized *Dryden*'s language. As one such court pointed out:

We do not find this statement controlling in our case because it is plainly dictum and the cases cited by the author of the opinion, which was not written in but was adopted by the Supreme Court, do not support the statement. The cases, where the question is before the court, agree that the right to a pension is not a part of a contract which, having been entered into, cannot constitutionally be altered.¹⁷⁰

Although this statement accurately reflected California law as it existed at the time, it remained to be seen how the California Supreme Court would rule if and when it faced the issue in a case directly on point.

167. See *supra* Part I.D.

168. *Brooks v. Pension Bd.*, 85 P.2d 956, 958 (Cal. Dist. Ct. App. 1938); see also *Carr v. Fire Comm'n*, 85 P.2d 959, 960 (1938) (citing *Dryden*, but also stating that "[a] pension law may be changed or modified so long as the vital contingency has not happened upon which an employee may predicate his right to a pension").

169. *Brooks*, 85 P.2d at 958.

170. *Risley v. Bd. of Civil Serv. Comm'rs*, 140 P.2d 167, 171 (Cal. Dist. Ct. App. 1943); see also *England v. City of Long Beach*, 158 P.2d 589, 596 (Cal. Dist. Ct. App.) (noting that the statement in *Dryden* concerning pensions vesting on the first day of employment was without authority), *vacated by* 163 P.2d 865 (Cal. 1945).

2. The Long Beach Cases

Against this backdrop, a series of cases was decided in the 1940s and 1950s addressing actions the City of Long Beach took to repeal its pension system entirely for all current and future city employees. In the first of these cases, *Kern v. City of Long Beach*, decided in 1947, the California Supreme Court held that the city could not entirely eliminate its pension system.¹⁷¹ The case was brought by a current employee who, on the date the law was amended, was thirty-two days shy of having satisfied the law's twenty-year service requirement.¹⁷² The court began by acknowledging that prior California cases had held that there is a right to a pension only after all of the relevant contingencies have been met.¹⁷³ However, the court then took the opportunity to confirm the dictum in *Dryden*, which stated that the right to a pension vests upon acceptance of employment.¹⁷⁴ The court faced the apparent inconsistency in California rulings head-on, stating that pensions are part of the "contract of employment," but that public employment does not, itself, create a contract.¹⁷⁵ The court explained that "public employment gives rise to certain obligations which are protected by the contract clause of the Constitution, including the right to the payment of salary which has been earned."¹⁷⁶ The court's use of the past tense verb *earned* suggests that only past accruals are protected and not future benefits, which is consistent with the theory of pensions as a form of deferred compensation.

In trying to reconcile the various decisions regarding public pension benefits, the court stated that employees have a vested right to pension benefits, but

this right is not rigidly fixed by the specific terms of the legislation in effect during any particular period in which he serves. The statutory language is subject to the implied qualification that the governing body may make modifications and changes in the system. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension. There is no inconsistency therefore in holding that he has a vested right to a

171. *Kern v. City of Long Beach*, 179 P.2d 799, 803-04 (Cal. 1947).

172. *Id.* at 800.

173. *Id.* at 801.

174. *Id.* The court also cited the case of *French v. French*, 112 P.2d 235 (Cal. 1941), *overruled on other grounds* by *Brown v. Brown (In re Marriage of Brown)*, 15 Cal. 3d 838 (1976), as authority for this position. *Kern*, 179 P.2d at 801. The *French* case, however, dealt with a pension earned while serving in the U.S. Navy, and the court merely repeated the *Dryden* dictum and stated that the case was "not on point." *French*, 112 P.2d at 236.

175. *Kern*, 179 P.2d at 801-02.

176. *Id.* at 802.

pension but that the amount, terms and conditions of the benefits may be altered.¹⁷⁷

The court explained that allowing for such modifications is necessary because “pension systems must be kept flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy.”¹⁷⁸ In other words, the broad implication of this holding was to prohibit the state from completely eliminating pension benefits, as was attempted by the city in the case at bar. However, the case was silent about exactly what modifications the court would allow after an employee commences work but before he or she retires.

As in previous cases, the court did not go through the typical analysis required when holding that a statute creates a contract—the opinion contains no analysis of the statute’s wording or of the surrounding legislative intent. It is also worth noting that while the court held that participants have constitutionally protected contractual rights, the court allowed for reasonable modifications of that contract.¹⁷⁹ This standard, however, is not necessarily consistent with the bounds of the contract clause, but because the court did not provide the contours of the permissible modifications, it is difficult to discern.¹⁸⁰

The court also made repeated references throughout the opinion to the status of pensions as a form of deferred compensation. The court cited a New York opinion that stated that pension benefits “are in the nature of compensation for the services previously rendered They are in effect pay withheld to induce long-continued and faithful services.”¹⁸¹ Similarly, the court in its own words described pension benefits as a form of deferred compensation and stated that “the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.”¹⁸² The court noted that not only can the state not impair the obligation to pay pension benefits after all contingencies have been satisfied but also that it cannot impair the obligation “at any time after a contractual duty to make salary payments has arisen, since a part of the compensation which the employee has at that time earned consists of his pension rights.”¹⁸³ The analogy to the protection

177. *Id.* at 803.

178. *Id.*

179. *See id.*

180. For a discussion of the interaction between the California Rule and the traditional contract clause analysis, see *infra* Part II.E.

181. *Kern*, 179 P.2d at 801 (quoting *Giannettino v. McGoldrick*, 66 N.E.2d 57, 59 (N.Y. 1946)) (internal quotation marks omitted).

182. *Id.* at 803.

183. *Id.*

granted to salaries is explicit, which strongly suggests that only benefits that have already been accrued and earned through service will be protected.

All in all, the holding in *Kern* moves California law away from the position that an employee only has rights related to pension benefits once all contingencies are met to one in which there are some restrictions on preretirement changes. Despite the change, the *Kern* holding still appears to retain some flexibility for the state to make pension changes. *Kern's* holding reflects a balancing between employee rights and state needs, and appears to be using contractual language in a somewhat loose sense.

a. Reasonable Modifications Under Kern

It was left to courts after *Kern* to determine exactly which modifications would be considered “reasonable.” Notably, three appellate courts held that it was permissible under the test in *Kern* to eliminate future benefit accruals once a minimum pension had been earned.¹⁸⁴ Similarly, the California Supreme Court held that it was permissible to eliminate certain survivor benefits where beneficial changes were simultaneously made to an employee’s regular pension benefit.¹⁸⁵ The court allowed the change even though it could not determine the relative monetary value of the benefits and detriments.¹⁸⁶ It focused instead on the fact that after the change, the participant retained the right to a “substantial pension.”¹⁸⁷

Changes that completely eliminated a participant’s pension benefit were, consistent with the holding in *Kern*, struck down. For example, the California Supreme Court held that amending a pension statute to require pension forfeiture upon a felony conviction was not a reasonable modification where the amendment was enacted after a participant had retired.¹⁸⁸ As the court explained, “The termination of all pension rights upon conviction of a felony after retirement does not appear to have any material relation to the theory of the pension system or to its successful operation.”¹⁸⁹ Although this language did not actually appear in *Kern*, the court evidently interpreted the standard in *Kern* to require modifications that were designed to maintain the integrity of the system. Because the court characterized the change—which was designed to help the city respond to the objection of taxpayers opposed to paying pension benefits to felons—as one beneficial to the city, rather than as a change designed to maintain the

184. See *Allstot v. City of Long Beach*, 231 P.2d 498, 500 (Cal. Dist. Ct. App. 1951); *Allen v. City of Long Beach*, 224 P.2d 792, 794–95 (Cal. Dist. Ct. App. 1950); *Palaske v. City of Long Beach*, 208 P.2d 764, 771–72 (Cal. Dist. Ct. App. 1949).

185. *Packer v. Bd. of Ret. of L.A. Cnty. Peace Officers’ Ret. Sys.*, 217 P.2d 660, 664–65 (Cal. 1950).

186. *Id.*

187. *Id.*

188. *Wallace v. City of Fresno*, 265 P.2d 885, 887 (Cal. 1954).

189. *Id.*

integrity of the pension system, the court held the change to be unreasonable.¹⁹⁰

Similarly, a California appellate court held that adopting a new, less generous pension formula was an unreasonable modification under the *Kern* standard.¹⁹¹ In that case, the pension formula was amended to use a fixed benefit amount, rather than a benefit amount that fluctuated with the salary of active employees.¹⁹² Not only was this clearly a detrimental change, but it was also one with retroactive impact, effectively lowering the pension benefits the participant had already earned.¹⁹³

Although courts have not decided many cases under the *Kern* standard, the cases that do exist demonstrate a willingness to allow prospective changes while prohibiting retroactive changes that significantly decrease the benefit to participants. The *Kern* standard, however, was not long-lived, as the California Supreme Court issued a ruling in a new case involving the City of Long Beach that fundamentally changed the legal standard for changes to public employee pension benefits.

b. The Introduction of the “Comparable New Advantages” Requirement in Allen v. City of Long Beach

In *Allen v. City of Long Beach*, decided by the California Supreme Court in 1955, the court considered whether the city could amend its existing pension system for current employees by (1) increasing employee contributions, (2) changing the method of calculating benefits from one in which benefits fluctuated with current salaries to one in which benefits were fixed at retirement, and (3) requiring employees who were absent from work during military service to contribute an amount equal to what would have been deducted from their salaries if they had not been absent.¹⁹⁴ The court held all three changes to be impermissible under the *Kern* standard, stating for the first time that

[a]n employee’s vested contractual pension rights may be modified prior to retirement 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. Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees’ pension rights must bear some material relation to the theory of a pension system and its successful operation, and

190. *Id.* at 887–88.

191. *English v. City of Long Beach*, 272 P.2d 875, 878–79 (Cal. Dist. Ct. App. 1954).

192. *Id.* at 876–77.

193. *See id.*

194. *Allen v. City of Long Beach*, 287 P.2d 765, 766–67 (Cal. 1955).

changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.¹⁹⁵

It is in this case, therefore, that the final piece of the California Rule dropped into place, and it did so without much discussion.¹⁹⁶ Instead, the court merely stated the new rule and cited two appellate court decisions as authority to support its new requirements—that changes be consistent with the theory of a pension system and that all detrimental changes be offset by “comparable new advantages.”¹⁹⁷ While the cited appellate decisions mentioned the theory of a pension system and noted that certain detrimental changes were offset by new advantages, it is unclear why the *Allen* court chose to make these appellate court observations part of a new rule regarding pension modification.

The *Allen* case is a bombshell. With an analysis that can charitably be described as both stretching existing authority and inconsistent with state and federal Contract Clause jurisprudence, the California Supreme Court announced a completely new standard for evaluating changes to public pension benefits. Not only did the court fail to analyze the statutory language and the surrounding circumstances in determining whether the legislature intended to create a contract, it impliedly held that the state could make “reasonable” modifications to the contract as long as such changes were consistent with the theory of a pension system and any detrimental changes were offset by comparative new advantages. These parameters that the *Allen* court placed on permissible pension changes are not consistent with the test generally used under the Contract Clause to determine whether contract amendments are constitutionally permissible.¹⁹⁸

195. *Id.* at 767 (citations omitted). As authority for the statement, the court cited both the *Packer* and *Wallace* cases discussed above. *Id.* The *Packer* case is indirect support for this test, at best. *Packer* considered whether changes to a pension law prior to retirement were “reasonable modifications” under the test in *Kern*. *Packer v. Bd. of Ret.*, 217 P.2d 660 (Cal. 1950). While the changes were characterized as having “advantages and disadvantages,” there was no attempt to balance the two. *See id.* at 661. Rather, the court seemed to focus on the fact that “[t]he basic conditions under which a county peace officer could obtain a pension were substantially unchanged.” *Id.* at 664. Indeed, the court noted that it would be “difficult, if not impossible,” to determine whether the “total value of all pension rights, considered together, had been reduced and, if so, to what monetary extent.” *Id.* However, the court found such balancing unnecessary to reach its decision. *Id.* at 664–65.

196. In this particular case, the city lost because it apparently admitted that the changes were made not for any reason related to the theory of a pension system, but to “ameliorate ‘personal problems’” caused by benefit differences between new employees and existing employees. *Allen*, 287 P.2d at 768.

197. *Id.* at 767 (citing *Wallace v. City of Fresno*, 265 P.2d 884, 887–88 (Cal. 1954), and *Packer*, 217 P.2d at 661–62, 664–65).

198. For a detailed discussion of the interaction between the California Rule and traditional contract clause jurisprudence, see *infra* Part II.E.

This new standard drastically limits the ability of the state to make changes to the pension benefits of current employees. Whereas, prior to *Allen*, the cases held only that the state could not eliminate pension systems in their entirety, the *Allen* court's new standard essentially prohibits any type of detrimental change to those benefits.

At the time *Allen* was decided, the exact contours of its rule were unclear. For instance, the court did not explain when it would consider a change to be materially related to the theory of a pension system. And, perhaps more importantly, it was unclear whether the rule would be interpreted only to prevent detrimental changes to pension benefits that had already been accrued, or whether it would also apply to limit the state's ability to make changes to pension benefits earned for services provided to the employer after the effective date of a change. A rule that only protected accrued benefits would be consistent with the theory of pensions as deferred compensation; whereas a rule that protected future accruals without evidence of an explicit agreement on the matter would be a significant, unprecedented change that goes beyond any known theory of deferred compensation.¹⁹⁹ The Subpart below explores how California courts have interpreted and applied the standard announced in *Allen*.

D. THE EVOLUTION OF THE ALLEN STANDARD

As in the *Kern* decision, there was much left unsaid in the *Allen* decision, particularly what it meant for a change to bear a "material relation to the theory of a pension system," how the "comparable new advantages" test would be administered, under what circumstances a court would consider a change to be a "reasonable" modification, and also whether the state would retain the ability to modify future accruals for employees who were already members of a state retirement plan.

1. Material Relation to the Theory of a Pension System

While the California Supreme Court announced in *Allen* that it would only uphold changes to public employee pensions that bear a material relation to the theory of a pension system, there is relatively little case law expanding on what this standard means. As discussed above, in one case the California Supreme Court held that amending a pension statute to provide for the forfeiture of a pension upon a felony conviction was a change that did not bear any "material relation to the theory of a pension system."²⁰⁰ Instead, the court characterized the change as one that was designed to

199. This statement assumes, because of a lack of evidence presented otherwise, that there was no explicit agreement between the parties with respect to either a specific duration of employment or pension accruals during any specified period. Rather, this statement assumes that the only basis for holding that a contract exists was the circumstances surrounding the pension legislation.

200. *Wallace*, 265 P.2d at 887–88.

benefit the city by “meet[ing] the objections of taxpayers who would be opposed to contributing funds for the maintenance of a pensioner who had been convicted of a felony.”²⁰¹ Thus, because it seemed that this change was driven by factors external to the pension system, it was not considered materially related to the theory of a pension system.

Courts have also made clear that poor funding status is not enough to satisfy the “material relation” standard.²⁰² In one such case, upon the advice of actuaries, a local pension system that faced an unfunded liability of nearly \$40 million sought to increase employee contributions to alleviate the unfunded liability.²⁰³ The court refused to allow the change and, in discussing the “theory of a pension system” standard, explained that “[t]here has been no showing of extreme hardship by the city nor has there been a showing that the system would collapse without employee financing of past unfunded liability.”²⁰⁴

In perhaps the bluntest statement, one court characterized the theory of a pension system as simply “affording retirees with a reasonable degree of economic security.”²⁰⁵ If that is the correct standard, it is difficult to see how any detrimental change would be permissible, unless the change were necessary to preserve limited benefits in the case of insolvency.

2. Comparable New Advantages

Following the *Allen* decision, courts had little difficulty rejecting pension changes that were clearly detrimental with no comparable new advantage. For example, a statutory change adding a new dollar-amount maximum for pension benefits was impermissible because the change came with no comparable advantage to participants.²⁰⁶ Similarly, increases in the rate of employee contributions were held to be unreasonable where they were not accompanied by any new advantage.²⁰⁷

In those cases where the existence of comparable new advantages was a genuine issue, California courts made clear that the new advantages had to

201. *Id.* at 887.

202. *See* *Abbott v. City of San Diego*, 332 P.2d 324, 330 (Cal. Dist. Ct. App. 1958) (finding that while the city had demonstrated pension fund insolvency concerns, the changes made did not “bear any material relation to the integrity or successful operation or to the preservation or protection of the pension program applicable to these plaintiffs” (emphasis omitted) (quoting *Abbott v. City of L.A.* 326 P.2d 484, 489 (Cal. 1958)) (internal quotation marks omitted)); *Ass’n of Blue Collar Workers v. Wills*, 232 Cal. Rptr. 174, 182–83 (Ct. App. 1986).

203. *Ass’n of Blue Collar Workers*, 232 Cal. Rptr. at 176–77.

204. *Id.* at 182–83 (noting further that there was no evidence that the system was “on the brink of insolvency”).

205. *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 74 (Ct. App. 1989).

206. *Chapin v. City Comm’n*, 307 P.2d 657, 660 (Cal. Dist. Ct. App. 1957).

207. *Wisley v. City of San Diego*, 10 Cal. Rptr. 765, 767–68 (Ct. App. 1961).

be contemporaneous with the detrimental changes.²⁰⁸ The state could not cite continual improvements in pension benefits over the years as a comparable new advantage to a currently enacted detriment.²⁰⁹ In addition, the advantages have to be available to the same group on whom the disadvantages are placed.²¹⁰ Similarly, improvements made to a regular, or “service,” pension could not be used to outweigh detrimental changes made to pensions payable in the event of disability.²¹¹ However, courts have stated that a “precise dollar balance” does not have to be struck as long as the “modification does not frustrate the reasonable expectations of the parties to the contract of employment.”²¹² Additionally, at least one court has held that if a single individual will be harmed by the change, even if the majority of participants might be better off, the change cannot be applied to those individuals who would be harmed by the amendment.²¹³

In one case, a court found that the disadvantages caused by the implementation of a minimum age for receipt of a pension, where previously there had been none, and a change from a pension formula that fluctuated with active employee salaries to one that was fixed, were not outweighed by the new advantages of lowering the number of years of service required for a full pension from thirty years to twenty-five years.²¹⁴ In explaining why the advantage was not comparable to the disadvantages, the court gave the example of an employee who had thirty years of service, but was only fifty years old. That individual would, under the new statutory provisions, have to work an additional five years in order to receive a full pension.²¹⁵ Accordingly, because the advantage would not extend to the plaintiffs bringing the legal challenge, the change was not permitted to be applied to the plaintiffs. After *Allen*, then, California courts had to weigh on an individualized basis any detrimental changes to a pension against advantages enacted at the same time.

208. See, e.g., *Betts v. Bd. of Admin. of the Pub. Emps.’ Ret. Sys.*, 582 P.2d 614, 619 (Cal. 1978) (improvement enacted in 1963 could not be used to justify detrimental change in 1974); *Abbott v. City of San Diego*, 332 P.2d 324, 329 (Cal. Dist. Ct. App. 1958).

209. *Betts*, 582 P.2d at 619; *Abbott*, 332 P.2d at 329.

210. *Abbott*, 322 P.2d at 329.

211. *Frank v. Bd. of Admin. of the Pub. Emps.’ Ret. Sys.*, 128 Cal. Rptr. 378, 383–85 (Ct. App. 1976).

212. *Id.* at 383–84.

213. See *Phillis v. City of Santa Barbara*, 40 Cal. Rptr. 27, 38–39 (Ct. App. 1964); see also *Betts*, 582 P.2d at 617 (stating that the determination of comparable advantages and disadvantages “must focus on the particular employee whose own vested pension rights are involved”).

214. *Phillis*, 40 Cal. Rptr. at 36–39.

215. *Id.* at 36. Similarly, a court held that an advantage a participant may only avail herself of by retiring earlier than she anticipated cannot be a comparable advantage. See *Stork v. State*, 133 Cal. Rptr. 207, 211–12 (Ct. App. 1976).

3. Reasonable Modifications

It is somewhat difficult to discuss the reasonableness requirement separately from the “comparable new advantage” and “theory of a pension system” requirements, because the courts often blend these requirements together. However, cases do sometimes require that the state establish reasonableness apart from these other factors. In holding changes to be reasonable, courts have often blessed relatively minor changes, none of which were retroactive in their effect on a participant’s benefit.

For example, a court held that a new requirement that “safety members”²¹⁶ of a retirement system submit to periodic physical examinations, when such examinations had not been required at the time the participant became part of the system, was a reasonable modification.²¹⁷ The court in this case did not compare the advantages and disadvantages of the change. Instead, the court simply held that requiring such examinations, where failing to submit to the examinations would result in the individual being eligible for a lower benefit accrual, rather than complete pension forfeiture, was reasonable.²¹⁸

In another case, a court deemed that a required increase in the rate of employee contribution to a pension was a reasonable modification where an increase in pension benefits was simultaneously enacted.²¹⁹ And where a pension system was funded by employee contributions at rates determined by actuarial estimates, the California Supreme Court held that an increase in contribution rates was permissible even though there was no corresponding benefit associated with the increase.²²⁰ In that case, because the statute had contemplated that the rate would vary depending on actuarial estimates, the court found that rate changes driven by such actuarial estimates did not need to be offset by comparable new advantages.²²¹

4. A Break from *Allen* in *Lyon v. Fluornoy*?

While not part of the test announced in *Allen*, the concept of protecting a participant’s “reasonable expectations” appears in several decisions addressing changes to public pension benefits, as well as decisions examining contract clause challenges in other contexts. The U.S. Supreme Court has stated that “state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a

216. A “safety member” of the retirement system was a participant whose duties included “active law enforcement.” *Smith v. Nettleship*, 15 Cal. Rptr. 836, 838 (Ct. App. 1961). Safety members were eligible for more advantageous pension benefits than regular members. *See id.* at 842–43.

217. *Id.* at 843–44.

218. *Id.*

219. *City of Downey v. Bd. of Admin.*, 121 Cal. Rptr. 295, 302–04 (Ct. App. 1975).

220. *Int’l Ass’n of Firefighters v. City of San Diego*, 667 P.2d 675, 681 (Cal. 1983).

221. *Id.* at 678–79.

substantial impairment” of that contract.²²² California courts have cited with approval this notion that whether a party’s reasonable expectations have been defeated is relevant to establishing whether a substantial impairment has occurred.²²³

Such discussions have even taken place in the context of changes to public pension plans, despite the fact that the *Allen* test includes no reference to, or discussion of, such reasonable expectations.²²⁴ For example, in allowing the state to amend the legislators’ pension law to substitute a benefit formula based on the legislators’ current salary with one that fluctuates with the consumer price index, the court in *Lyon v. Fluornoy* focused on the reasonable expectations of pensioners.²²⁵ In that case, legislative salaries were being increased from \$500 per month to over \$1,300 per month, with the caveat that pensions for current retirees would not increase based on the new salaries, but rather would be indexed for inflation.²²⁶ In holding this change to be reasonable, the court stated, “To pay them allowances based upon the new . . . salary would hand them a bonanza far outstripping their expectations for cost-of-living increases, dwarfing their relatively modest contributions and demanding enlarged appropriations of general tax funds to maintain the retirement system’s solvency.”²²⁷ Indeed, the court explained, “[t]he law-making power chose to confine beneficiaries to the gains ‘reasonably’ to be expected from the contract’ and to withhold ‘unforeseen advantages’ which had no relation to the real theory and objective of the fluctuation provision. Such a choice is not . . . an impairment of the contract.”²²⁸

There are several aspects of this reasonable-expectations analysis that are notable. The first is that it seems inconsistent with the *Allen* test. After all, if we accept that a contract is formed as of the first day of employment and that any detrimental changes from that date must be offset by comparable new advantages, it is hard to see how this change would pass muster. Under the *Allen* test, the plaintiff had a contract for a pension that was based on the

222. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411 (1983); *see also Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 247 (1978); *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 20 n.17 (1977) (inquiring whether the impairment altered the parties’ “legitimate expectations”).

223. *See, e.g., Carpenter v. Carpenter (In re Marriage of Carpenter)*, 231 Cal. Rptr. 783, 786–87 (Ct. App. 1986); *Rue-Ell Enters., Inc. v. City of Berkeley*, 194 Cal. Rptr. 919, 922–23 (Ct. App. 1983).

224. *See, e.g., Betts v. Bd. of Admin.*, 148 Cal. Rptr. 158, 162–63 (1978); *Bellus v. City of Eureka*, 71 Cal. Rptr. 135, 143–45 (1968); *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 70–71 (Ct. App. 1989); *Frank v. Bd. of Admin.*, 128 Cal. Rptr. 378, 383–84 (Ct. App. 1976).

225. *Lyon v. Fluornoy*, 76 Cal. Rptr. 869, 877–78 (Ct. App. 1969).

226. *Id.* at 877.

227. *Id.* at 878.

228. *Id.*

active employee salary, which was clearly changed to the participant's detriment, and the new "advantage" hardly offset that detriment.²²⁹ In fact, it seems that the only way this change could survive the challenge is to limit the analysis to reasonable expectations as one would do under a traditional contract clause analysis. Notably, however, the court did so without acknowledging its apparent inconsistency with the *Allen* rule and *Allen's* rejection of the traditional contract clause analysis. Additionally, while this case did not deal with a prospective change, the language would seem to suggest that prospective changes may, in fact, be permissible in California. After all, it seems much harder to have reasonable expectations about events in the future than to have a reasonable expectation that benefits already earned through services performed will be paid as promised.

5. Future Accruals

One open issue for many years was how California courts would approach a purely prospective change to pension benefits; in other words, a change that preserved the pension benefits that an employee had already earned, but made a detrimental change to pension benefits that would be earned with respect to future service. Recall that it was not clear under the *Allen* test whether a change to future rates of accrual would be considered a detriment that had to be offset by comparable new advantages, since those benefits had not yet been earned. In addition, the California Supreme Court's endorsement of a reasonable-expectations standard also left open the possibility that prospective changes could be made, as it is not clear that such changes would interfere with a participant's reasonable expectations. However, California courts resolved this issue beginning in the 1980s by holding that future accruals are, in fact, protected from detrimental changes.²³⁰ In one case, the court simply stated that detrimental changes (regardless of whether they are prospective or not) must be offset by comparable new advantages in order to be permissible.²³¹ The cases discussed below engaged in a more thorough analysis of the issue.

In *United Firefighters of Los Angeles City v. City of Los Angeles*, decided in 1989, the city, while attempting to justify prospective pension changes, argued that (1) if pensions are deferred compensation, changes with respect to future service, for which compensation is not yet earned, should be permissible; and (2) an employee cannot have reasonable expectations with

229. Under the original contract, the participant would have been entitled to a pension calculated under the new \$1300 monthly salary. See *id.* at 778. Under the amendment, the participant was entitled to a pension based on a \$500 monthly salary, indexed for inflation. *Id.* The detriment from the change was therefore substantial.

230. *Legislature v. Eu*, 816 P.2d 1309, 1332 (Cal. 1991); *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 70-71 (Ct. App. 1989); *Pasadena Police Officers Ass'n v. City of Pasadena*, 195 Cal. Rptr. 339, 342-45 (Ct. App. 1983).

231. *Pasadena Police Officers Ass'n*, 195 Cal. Rptr. at 343.

respect to future accruals.²³² The appellate court rejected these arguments, stating that pension rights are “a contractual obligation from the moment one accepts public employment”²³³ and also that reasonable expectations for the future may be based on existing law.²³⁴ Essentially, the court determined that because the California Supreme Court had previously held that a contract is formed as of the first day of employment, it therefore follows that an individual’s reasonable expectations are set as of that date. While acknowledging that the ruling might be anomalous under general contract and deferred-compensation theories, it argued that California law was clear on the matter and that the interpretation had been sanctioned by the state’s highest court.²³⁵

In 1991, the California Supreme Court had the opportunity to consider the issue for itself in *Legislature v. Eu*. In *Eu*, the California Supreme Court went even further than the court in *United Firefighters*, explicitly recognizing the “collateral right to earn future pension benefits through continued service, on terms substantially equivalent to those then offered.”²³⁶ The authority cited as support for this right was *Carman v. Alvord*, a case dealing with whether a special property tax levy enacted for purposes of funding a city’s obligation to the Public Employees’ Retirement System (“PERS”) was constitutional.²³⁷ The *Carman* court stated in dictum that “[b]y entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer.”²³⁸ However, there was no further discussion of the contours of that right.

The court in *Eu* explicitly considered arguments based on the salary analogy. The respondents argued that because salary and tenure can be changed prospectively, pension benefits, as a form of compensation, can be prospectively changed as well.²³⁹ While not disputing the fact that salary and tenure can be changed, the court found that pensions are of a legal character different from salary because under prior California decisions pensions constitute a vested right as of the first day of employment.²⁴⁰ In

232. *United Firefighters*, 259 Cal. Rptr. at 69–70.

233. *Id.* at 69.

234. *Id.* at 70–71.

235. *See id.* at 68–69.

236. *Legislature v. Eu*, 816 P.2d 1309, 1331 (Cal. 1991) (emphasis omitted) (citing *Carman v. Alvord*, 644 P.2d 192 (Cal. 1982)).

237. *Carman*, 644 P.2d 192. California’s constitution limits property tax to 1% of property value, and the PERS assessment brought the tax above the 1% limit. *Id.* at 194. The question was whether the PERS assessment was “interest and redemption charges on any indebtedness” because, if so, it was exempt from the 1% limit. *Id.*

238. *Id.* at 195.

239. *Eu*, 816 P.2d at 1331–33.

240. *Id.* at 1333. The State argued that if it had the power to fire employees, it clearly had the power to eliminate future pension contributions under existing federal law, which allows for

other words, the court interpreted the holdings of *Kern* and *Allen* to protect both past and future pension accruals.

One interesting part of the *Eu* case is that the change at issue, which applied to both future and incumbent state legislators, not only impacted the right to earn future benefits but also the right to earn future vesting service.²⁴¹ The amendment at issue provided, among other things, that as of the date of adoption no participant in the legislative retirement plan should accrue any further benefit or any further vesting service.²⁴² For example, if an incumbent legislator had three years of service as of the date of the change and needed five years of service to qualify for a retirement benefit, that individual would never have the opportunity to vest because the terms of the amendment prohibited any further vesting service from accruing to any legislator. Thus, the pension benefit earned in the first three years of service would be forfeited under the plan's vesting provision. The court explicitly discussed this scenario and noted that prohibiting an individual from vesting in her pension benefit impairs that individual's contractual right.²⁴³ And this holding makes sense given that in this scenario, the law would operate to automatically forfeit the accrued benefit of any individual who was not fully vested as of the date of the amendment. As discussed earlier, forfeiting an individual's accrued benefit would be inconsistent with the theory of pensions as a form of deferred compensation. However, the court failed to recognize the important distinction between the right to *vest* in one's benefit (i.e., the right to earn service sufficient to earn a nonforfeitable benefit) and the right to *earn* an additional benefit (i.e., a pension of greater amount, based on future years of service).

In the end, despite California courts' repeated emphasis on pension benefits as a form of deferred compensation, the *Eu* court was explicit that "pension rights fall into a different category than salary rights."²⁴⁴ The *Eu* court, then, departed from prior holdings by stating, for the first time, that employees have an explicit *right* to earn future pension benefits through continued service and by distinguishing pension rights from salary rights.²⁴⁵ Both disregard the initial starting point of California courts that pensions are a form of deferred compensation, and appear to prevent the state from making any detrimental changes to pension benefits once an employee

prospective changes to a contract. *Id.* at 1334. Although the court ultimately rejected this argument, in doing so it noted that the federal Contract Clause issue is "not entirely free of doubt." *Id.*

241. *See id.* at 1314.

242. *Id.*

243. *Id.* at 1333.

244. *Id.* at 1332.

245. *See id.* at 1331-32.

begins work for the state.²⁴⁶ Further, the *Eu* case, like the others before it, is based on precedent that never examined whether the legislature clearly intended to create contractual pension rights.

E. *THE INTERSECTION OF THE CALIFORNIA RULE AND TRADITIONAL CONTRACT CLAUSE ANALYSIS*

Interestingly, over the many years that the California Rule developed, no direct reference was made to the contract clauses of the state or federal constitutions, or to the relevant tests for impairment that apply to such constitutional prohibitions.²⁴⁷ This is particularly interesting given that in other contexts, it is clear that the California Supreme Court applies the same analysis to claims of unconstitutional impairment of contract under the state constitution as it does under the federal Constitution.²⁴⁸

Recall that, under the standard contract clause analysis, a court determines whether a contract exists, whether there has been a substantial impairment of that contract, and if so, whether the impairment was reasonable and necessary to serve an important public purpose.²⁴⁹ Recall also that courts consider a contract impaired if it alters the contractual relationship between the parties.²⁵⁰ The court considers that impairment substantial where it defeats a party's reasonable expectations,²⁵¹ where "the right abridged was one that induced the parties to contract in the first place, or where the impaired right was one on which there had been reasonable and especial reliance."²⁵² Further, even if a substantial impairment exists, the change may nevertheless be permissible if it is a narrowly tailored response to a broad social issue.²⁵³ In addition, in determining reasonableness, the court takes into account the degree of impairment.²⁵⁴

246. One party to the litigation, Californians for a Citizen Government, petitioned for certiorari to the U.S. Supreme Court, arguing that the Court should take the case to reconcile the inconsistency between the California Supreme Court holding that a reduction in future pension accruals was an impairment of contract and the many federal and state courts that have held that there is no right to future accruals. Petition for Writ of Certiorari, *Eu*, 816 P.2d 1309 (No. 91-1114), 1992 WL 12074332. The Supreme Court denied the petition. *Californians for a Citizen Gov't v. Legislature*, 503 U.S. 919 (1992).

247. *Lyon v. Flournoy*, 76 Cal. Rptr. 869, 874 (Ct. App. 1969) ("There exists in California today a body of decisional law placing earned retirement rights within the shelter of the prohibition against contract impairment, without specific citation of either the federal or state clauses.").

248. See, e.g., *City of Torrance v. Workers' Comp. Appeals Bd.*, 650 P.2d 1162, 1164-65 (Cal. 1982); *Sonoma Cnty. Org. of Pub. Emps. v. Cnty. of Sonoma*, 591 P.2d 1, 4-6 (Cal. 1979).

249. See *supra* Part I.C.

250. See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 240 (1978).

251. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411 (1983).

252. *Balt. Teachers Union v. Mayor of Balt.*, 6 F.3d 1012, 1017 (4th Cir. 1993) (citations omitted).

253. See *supra* Part I.C.1.

254. *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 27 (1977).

The current interpretation of the California Rule is actually more strict than the traditional Contract Clause test because it (1) requires an impairment to be offset by a compensating advantage and (2) protects prospective changes. Because California courts rarely engage in the typical contract clause analysis in pension cases, it is difficult to determine how the two standards work together. Two possibilities seem obvious. One is that the California Rule is California's state-law interpretation of the test for unconstitutional impairment of contract. The problem is, in addition to being inconsistent with federal law, it is also inconsistent with how California courts approach contractual impairment in other contexts. And the courts never explain why this area of law is constitutionally exceptional. The other possibility is that the California Rule is simply the rule that applies when the state desires to make changes that are not justified by its police power. The problem with this approach is that under both federal and state constitutions, substantial impairments to contract are only permitted if they are justified under the state's police power. So if this second possibility is correct, it must be the case that the courts are not only finding evidence that the legislature intended to create the contract, but also that the contract includes a reservation by the state of the right to amend the contract where changes are consistent with the theory of a pension system and where detriments are offset by comparable new advantages. The legitimacy of such a finding is of course hard to evaluate, given that California courts do not discuss the factual basis on which they find a contract to have been created.

This last point brings us to perhaps the most significant criticism of the California Rule. California courts have put in place a highly restrictive legal rule that binds the legislature *without the court ever finding clear and unambiguous evidence of legislative intent to create a contract*.²⁵⁵ This break with traditional contract clause analysis is potentially the most troubling in that it infringes on the power of the legislative branch without apparent authority.

Despite ignoring the first step of traditional contract clause analysis, California courts do not ignore traditional contract clause analysis entirely in pension cases. For example, as discussed above, several California courts have examined "reasonable expectations" when determining the extent of contractual protection.²⁵⁶ In addition, in determining whether the state was permissibly exercising its police powers in changing pension benefits, one California court found it relevant that the state's own voluntary conduct had contributed to the need for the change.²⁵⁷ However, aside from these occasional borrowings of the standard contract clause analysis, it remains very difficult to understand what relationship exists between the California

255. California courts have openly acknowledged the need to find such unmistakable legislative intent. See *Claypool v. Wilson*, 6 Cal. Rptr. 2d 77, 91 (Ct. App. 1992).

256. See *supra* Part II.D.4.

257. *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 74-75 (Ct. App. 1989).

Rule and such analysis, particularly when California courts do not start their inquiry by looking for clear and unmistakable legislative intent to create a contract and do not explain the legal basis for finding that a contract exists.

F. ADOPTION OF THE CALIFORNIA RULE BY OTHER STATES

Despite the apparent flaws in the California Rule, twelve states²⁵⁸ have cited with approval the full California Rule as announced in *Allen*. Among these are Alaska,²⁵⁹ Colorado,²⁶⁰ Idaho,²⁶¹ Kansas,²⁶² Massachusetts,²⁶³ Nebraska,²⁶⁴ Nevada,²⁶⁵ Oklahoma,²⁶⁶ Oregon,²⁶⁷ Pennsylvania,²⁶⁸ Vermont,²⁶⁹ and Washington.²⁷⁰ In nearly all of these jurisdictions, the courts adopted the California Rule without much discussion, appearing to merely find it the most attractive of the available nongratiuity options. And none went through a typical analysis of statutory language or surrounding circumstances before finding the California Rule applicable. By failing to do so, they simply repeated the fundamental flaw in California's approach. In the years since these states adopted the California Rule, however, a handful have diverged from it in meaningful ways.

1. States That Adopted the California Rule and Later Modified It

Massachusetts, which has cited *Allen* with approval, nevertheless has held that detrimental changes can be made to pension benefits without

258. Maryland has adopted a rule with similar language to the California Rule, but has not directly adopted the California Rule and has indeed diverged from its core approach in important ways, and is therefore not included in the list of states adopting the California Rule. *See Davis v. Mayor of Annapolis*, 635 A.2d 36 (Md. Ct. Spec. App. 1994).

259. *Hammond v. Hoffbeck*, 627 P.2d 1052, 1057 (Alaska 1981) (noting "California's long experience with [the] problem" and adopting the rule from *Allen*). Alaska's adoption of the California rule is particularly interesting, given that it occurred in the context of interpreting Alaska's specific constitutional protection of public employee pensions.

260. *Police Pension & Relief Bd. v. Bills*, 366 P.2d 581, 584-85 (Colo. 1961); *see also City of Aurora v. Ackman*, 738 P.2d 796, 801 (Colo. App. 1987) (acknowledging the prior adoption of the *Allen* rule and citing later California cases regarding the application of the rule).

261. *Nash v. Boise City Fire Dep't*, 663 P.2d 1105, 1108-09 (Idaho 1983); *Hanson v. City of Idaho Falls*, 446 P.2d 634, 636 (Idaho 1968).

262. *Singer v. City of Topeka*, 607 P.2d 467, 475 (Kan. 1980).

263. *Dullea v. Mass. Bay Transp. Auth.*, 421 N.E.2d 1228, 1235 (Mass. App. Ct. 1981).

264. *Calabro v. City of Omaha*, 531 N.W.2d 541, 552 (Neb. 1995).

265. *Pub. Emps.' Ret. Bd. v. Washoe Cnty.*, 615 P.2d 972, 974-75 (Nev. 1980).

266. *Taylor v. State & Educ. Emps. Grp. Ins. Program*, 897 P.2d 275, 279 (Okla. 1995) (requiring that the change "not impair the actuarial soundness of the fund, or detrimentally affect vested rights" as additional factors under the California Rule).

267. *Or. State Police Officers' Ass'n v. State*, 918 P.2d 765, 773 n.14, 775 n.18 (Or. 1996).

268. *Catania v. Commonwealth*, 450 A.2d 1342, 1349-50 (Pa. 1982).

269. *Burlington Fire Fighters' Ass'n v. City of Burlington*, 543 A.2d 686, 690 (Vt. 1988).

270. *McAllister v. City of Bellevue Firemen's Pension Bd.*, 210 P.3d 1002, 1004 (Wash. 2009); *Bakenhus v. City of Seattle*, 296 P.2d 536, 538-41 (Wash. 1956).

comparable new advantages.²⁷¹ In the *Dullea* case, the court allowed a complete repeal of a deferred-compensation plan providing increased retirement benefits, thirty-seven days after it was enacted, even though participants had signed an explicit agreement granting such benefits.²⁷² The court diverged from the California cases in stating that the “contract” for pension benefits “protects the member of a retirement plan in the core of his reasonable expectations, but not against subtractions which, although possibly exceeding the trivial, can claim certain practical justifications.”²⁷³ Further, the court noted that

reasonably based reliance by public employees on an express promise that their pensions are irrevocable gives those employees a vested right sufficient to bar a reduction of those benefits below the level existing when the employees first began work, or the level existing at the point when the promise had created expectations firm enough to command judicial respect.²⁷⁴

The court stated, in essence, that the “entitlements of both parties [are] subject to reasonable limitations.”²⁷⁵ In deciding the issue, the court found that the employer’s promise was “short-lived” and that “[t]he plaintiff took no decisive action in reliance on the promise of more benefits, nor did he perform any substantial services for a significant period based on his agreement.”²⁷⁶ As a result, the state agency was permitted to rescind the new plan in its entirety.²⁷⁷ Allowing such a rescission, while likely dependent on the particular facts at issue, appears more consistent with a promissory estoppel²⁷⁸ approach than with the California Rule.

Cases in Oregon, which has also adopted the California Rule, have broken from California’s jurisprudence with respect to future accruals. For example, in *Hughes v. State*, the Oregon Supreme Court allowed the State to remove the existing state tax exemption for public employee pension benefits, but only for those benefits that were not earned as of the date of the tax change.²⁷⁹ The relevant statutory language provided that retirement

271. See *Dullea v. Mass. Bay Transp. Auth.*, 421 N.E.2d 1228, 1235–36 (Mass. App. Ct. 1981).

272. *Id.*

273. *Id.* at 1234 (quoting Op. of the Justices, 303 N.E.2d 320, 328 (Mass. 1973)) (internal quotation marks omitted).

274. *Id.* at 1234–35 (footnotes omitted).

275. *Id.* at 1235.

276. *Id.* at 1235–36.

277. *Id.*

278. *Promissory estoppel* is a legal doctrine that applies to enforce a promise where a promise was made that the “promisor should reasonably expect to induce action or forbearance . . . on [the] part of the promisee, which does induce such action or forbearance” and where justice requires enforcement of the promise. BLACK’S LAW DICTIONARY 1214 (6th ed. 1990).

279. *Hughes v. State*, 838 P.2d 1018, 1033–34 (Or. 1992).

benefits “accrued or accruing” shall be exempt from all state and local taxes “heretofore or hereafter” imposed.²⁸⁰ The court interpreted the statutory language to create a contract that included the right to have benefits exempt from state taxation, but only with respect to benefits that had already been earned through service.²⁸¹ Hence, the state was free to tax benefits not yet earned. It was therefore through examining the statutory language and the legislature’s intent that the state diverged from the California Rule.

Very recently, a lower court in Colorado appeared to break from the California line of cases, which were previously endorsed by the Colorado Supreme Court.²⁸² In the Colorado case, the district court was considering whether the state was permitted, as part of a broad pension reform effort, to reduce the cost-of-living adjustments (“COLAs”) previously granted to retirees.²⁸³ The plaintiffs included individuals who had retired under Colorado’s public employee retirement system at a time when there was a guaranteed 3.5% COLA in place.²⁸⁴ This COLA had been in place since 2001.²⁸⁵ Under the California Rule, it is clear that COLA reductions could not be made once a participant entered the system.²⁸⁶ However, the Colorado District Court held that the statute granting COLAs contained no clear and unambiguous evidence that retirees were entitled to an unchanged COLA for the duration of their benefits.²⁸⁷ In further support of its conclusion, the court highlighted the fact that COLAs had previously been changed (though not to a retiree’s detriment), and therefore those in the system could have no reasonable expectation of an unchanged COLA.²⁸⁸ The court’s ruling is surprising both because the court broke from the previously endorsed California Rule, under which it is clear that detrimental changes to the benefits of current employees are only permissible where they are offset with comparable new advantages, and because the change at issue is one that could be characterized as a retroactive change to benefits, which is the type of change that invites the most scrutiny under a contract clause analysis.²⁸⁹ And like Oregon, the Colorado court broke away from the

280. *Id.* at 1033 (emphasis omitted) (quoting Or. Rev. Stat. § 237.201 (1989)).

281. *Id.* at 1033–34.

282. *Justus v. State*, No. 2010-CV-1589, slip op. at 9 (Colo. Dist. Ct. June 29, 2011).

283. *Id.* at 1–2.

284. *Id.* at 8.

285. *Id.* at 6.

286. *See* *Legislature v. Eu*, 816 P.2d 1309, 1332–33 (Cal. 1991).

287. *Justus*, slip op. at 9.

288. *Id.* at 7–9.

289. For example, a participant who worked for the state from 2001 (when the 3.5% COLA was enacted) until 2010 (when the COLA was reduced) would have worked for nine years in exchange for the promise of a benefit that increased by 3.5% each year during retirement. If that COLA benefit is part of what an employee earns through services rendered,

California Rule by returning to the first step of a contract-based claim—examining the statute and its surrounding circumstances for an unmistakable legislative intent to create a contract.

2. Critiques of the California Rule

While California's approach to public pensions has been widely influential, there are a few states that have considered the approach and explicitly rejected it. For example, in the 1960s the New Jersey Supreme Court rejected the California approach and pointed out that it was odd to simultaneously hold that a contract exists and that it can be unilaterally modified by the state (as such unilateral modifications are inconsistent with traditional contract theory).²⁹⁰ The court stated:

The California cases cited in the paragraph above recognize a legislative power of revision, with the proviso that a benefit that is taken away is reasonably offset by something added. True the needed power in the Legislature to revise a plan without the consent of the parties to the "contract" could be said to be "implied," but it seems odd to say the State may unilaterally rewrite its own contract or rewrite contracts between its municipal agents and others. We think it more accurate to acknowledge the inadequacy of the contractual concept.²⁹¹

Maine, like New Jersey, rejected a contractual approach to public pensions, and instead found that participants may have property rights in such pensions that cannot be destroyed without due process of law.²⁹² The Maine court expressed its concern that finding a contract in the absence of clear evidence would infringe on legislative power. The court explained:

We are unpersuaded by the reasoning of those jurisdictions that have discerned in the statutory language the creation at the time of employment of binding contractual rights. *See, e.g., Betts v. Board of Administrators of Pub. Employees Retirement Sys.*, 21 Cal. 3d 859, 148 Cal. Rptr. 158, 582 P.2d 614 (Cal. 1978). Our retirement statute contains no language expressing an intent to create such rights and we decline to imply them in the absence of such language. To rule otherwise would prohibit the State from amending its retirement

the change at issue in Colorado would properly be considered retroactive. The district court in Colorado at the very least implicitly disagreed with this characterization.

290. *Spina v. Consol. Police & Firemen's Pension Fund Comm'n*, 197 A.2d 169, 176 (N.J. 1964).

291. *Id.*

292. *Spiller v. State*, 627 A.2d 513, 516–17 & n.12 (Me. 1993).

plan without giving many years of notice and would unduly restrict the power of the legislature.²⁹³

In declining to find that a contract existed, Connecticut similarly focused on the requirement of clear and unambiguous evidence that the legislature intended to create a contract.²⁹⁴ As the Connecticut Supreme Court explained, “When the legislature intends to surrender its power of amendment and revision by creating a contract and thereby binding future legislatures, it must declare that intention in clear and unambiguous terms.”²⁹⁵

Interestingly, even some of the states that have adopted the California Rule have pointed out its flaws. A Massachusetts appellate court noted that

[c]ontract analysis is cumbersome and suffers from at least two flaws. First, it distorts reality, because the establishment of a governmental pension plan bears at most only a general resemblance to negotiation and formation of a contract. . . . The second infirmity in the contract analysis is that, by freezing the provisions of the plan without any adjustments, serious harm can occur to the governmental entity that created it. Changes in policies, commitments, and financial conditions can make plans drafted under favorable conditions unrealistic and burdensome on the government employer.²⁹⁶

Even though the California Rule has been widely adopted and influential, courts in some states have critiqued the rule on grounds similar to those raised in this Article—that the rule ignores evidence of legislative intent and distorts traditional contract theory.

III. UNPACKING THE LEGAL AND PRACTICAL IMPLICATIONS OF THE CALIFORNIA RULE

The California Rule is interesting for a number of reasons. Its historical development is interesting in its own right, but so, too, is the legal theory underlying it. The California Rule also has enormous practical impact both for public employees and for the state government and the taxpayers that support it. This Part examines the California Rule as legal theory, assessing it from the perspective of contract law and economic theory. While this Part concludes that the California Rule fails to establish the necessary legislative intent to form a contract and is inconsistent with general contract and economic theory, it also suggests that the courts’ real concern may have

293. *Id.* at 516–17 (footnote omitted).

294. *Pineman v. Oechslin*, 488 A.2d 803, 809–10 (Conn. 1985).

295. *Id.* at 809.

296. *Dullea v. Mass. Bay Transp. Auth.*, 421 N.E.2d 1228, 1234 n.9 (Mass. App. Ct. 1981).

been the long vesting periods that often applied to participants in public pension plans.

A. *THE FLAWED LEGAL THEORY*

As a legal rule, the California Rule is anomalous. It is not based on clear and unambiguous evidence that the legislature intended to create a contract, it differentiates pensions from compensation generally, and it protects not only benefits that have been earned but also the rate of future accruals. This first anomaly is significant, since it binds the legislature without first finding clear and unambiguous evidence that the legislature intended to form a contract. The courts that established the California Rule simply never undertook the relevant analysis. This is not surprising, given that the California Rule sprang from a sentence of dictum that referred to pensions as “in a sense” part of the contract of employment. Ultimately, this sentence gained legal significance because subsequent courts never corrected this oversight and simply relied on the statement regardless of its precedential value.

The failure to even attempt to discern legislative intent creates a separation-of-powers issue. Courts that bind legislatures, absent clear indication that a legislature intended to bind itself in perpetuity, are infringing on legislative power.²⁹⁷ The federal courts’ presumption that statutes do not create contracts reflects concern over this potential infringement. As the U.S. Supreme Court has explained, “to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body.”²⁹⁸ However, the California courts do not appear to share this concern.

The second anomaly of the California Rule is that it clearly separates the legal protection of pensions from the legal protection for employee compensation generally. This is despite the fact that California courts have repeatedly referred to pensions as a form of deferred compensation. The reason for this distinction is unclear, other than the fact that the rule developed by California courts for public employee compensation was so drastically different from the rule developed for public employee pensions that the legal distinction had to be acknowledged, if not explained.²⁹⁹ And

297. *Nat’l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*, 470 U.S. 451, 465–66 (1985) (citing *Dodge v. Bd. of Educ.*, 302 U.S. 74, 79 (1937)).

298. *Id.* at 466.

299. The exceptionalism of the legal protection granted to pensions over other forms of compensation leads to some anomalous results. For example, the state was permitted to lower the amount of interest it paid on pension fund contributions that were withdrawn by participants prior to retirement. It could do so because the court characterized the withdrawal of contributions prior to retirement as a benefit of “employment” (which is not entitled to contractual protection) rather than a “retirement” benefit (which could not be changed to an employee’s detriment after the first day of employment). *Vielehr v. State*, 163 Cal. Rptr. 795, 797–98 (Ct. App. 1980).

since the court never justifies the existence of the pension contract in the first place, it is difficult if not impossible to know what it is about pensions that requires different treatment from other compensation.

Finally, and related to both of the points above, the California Rule is anomalous in its protection of future accruals. There is no question that if an employer and an employee entered into a formal, fixed-duration employment contract at a specific salary and with a specific pension accrual that the employee would be entitled to enforce that contract.³⁰⁰ The fact that the contract is for a specific period of employment would allow the employee to challenge any changes to pension accruals during the period of employment, even if such changes were “prospective.” Public employees, however, are generally at-will employees, with no guaranteed period of employment. It is this distinction that creates problems with legally protecting future accruals. After all, if your employment can be terminated and your salary lowered prospectively, what is the basis for finding a right to future accruals? The problem, of course, is that California courts have never explained the basis for protecting future accruals. They simply treat it as a given, which is problematic because both federal Contract Clause jurisprudence³⁰¹ and public-employment rights generally suggest that prospective changes in this context are permissible.

Considering that nearly all other terms and conditions of employment can be changed prospectively, it is difficult to see why pension accruals enjoy special protection. One possible distinction may be that retirement benefits provided by traditional defined benefit plans are typically accrued disproportionately in the later years of an employee’s career.³⁰² For example, assume that an employee who begins her career earning an annual salary of \$20,000 has a thirty-year career and earns \$100,000 during the year prior to retirement. If that employee works for an employer that provides a pension that is equal to 2% of the employee’s final compensation multiplied by years of service, that employee would be entitled to an annual pension of \$60,000. However, assume that the employer eliminates the pension plan when the employee has worked for the employer for only fifteen years. If the employee is earning \$60,000 at the time of plan termination, she would be entitled to an annual pension of only \$18,000, less than a third of the pension she would have received if the plan remained in place, even though

300. See 30 C.J.S. *Employer–Employee* § 29 (2011) (discussing fixed-term employment contracts); *id.* § 27 (discussing permissible modifications to employment contracts); *id.* § 28 (discussing remedies for the breach of an employment contract). Calculating the damages for a breach of the contract in these circumstances is perhaps not so simple, but for now the important point is that a contract that provided for specific pension accruals over a guaranteed period of employment could be enforced.

301. See, e.g., *Robertson v. Kulongoski*, 359 F. Supp. 2d 1094, 1100 (D. Or. 2004); *Howell v. Anne Arundel Cnty.*, 14 F. Supp. 2d 752, 755–56 (D. Md. 1998).

302. See, e.g., Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 688 (2000) (explaining why defined benefit plans are typically backloaded).

she is halfway through her career. The fact that pension benefits are often disproportionately earned during the years closest to retirement is often referred to in the pension literature as the *backloading* of benefits.³⁰³

Does the fact that pension benefits are backloaded change an employee's reasonable expectations? It is hard to argue that it changes expectations because an employee generally does not have reasonable expectations with respect to length of employment, salary level, or other terms and conditions of employment. One might argue that backloading benefits creates a promissory estoppel claim—that the state induced public employees to accept a job with the state for lower levels of cash compensation in return for a valuable pension accrual in the latter years of employment and that the employee acted in reliance on this promise by accepting state employment in lieu of other opportunities. The problem, it seems, with such a claim is that it is unlikely to be reasonable to rely on future years of pension accruals when you are aware that your employment can be terminated at will. Perhaps what the issue of backloading provides is a nonlegal rationale for why courts might want to protect future accruals for defined benefit plans. It is interesting to note, however, that the California Rule appears to apply not only to defined benefit plan accruals but also to defined contribution plan accruals.³⁰⁴ In other words, if an employee was a participant in a defined contribution plan to which the state contributed 8% of the employee's salary, the California Rule would prevent the state from lowering its contribution rate even though benefits under such a plan are accrued steadily and are not backloaded. For all of these reasons, the fact that traditional pension plan benefits are backloaded does not appear to provide legal justification for the California Rule.

It might also be the case that because these pension plans are, for some employees, a substitute for Social Security benefits, reasonable expectations include an expectation of continued benefit. After all, for those employees who do not participate in the federal Social Security system, these benefits represent the sole form of retirement security from governmental sources. The policy issue here is very real. But it actually shows one of the weaknesses of the contractual approach. There is nothing in contract theory that supports the notion that just because something is of critical importance to an individual it is protected by contract. Indeed, there is no contractual right to federal Social Security benefits.³⁰⁵ We are left, then, with a dissatisfactory account of the legal basis for the California Rule. No clear and

303. *See id.*

304. While my research identified no California state cases addressing a detrimental change to a defined contribution plan formula, there is no language or reasoning in the line of California pension cases to suggest that the rule applies only to retirement benefits paid from a defined benefit plan.

305. *See Flemming v. Nestor*, 363 U.S. 603, 610 (1960) (describing the right to Social Security benefits as “noncontractual”).

unambiguous legislative intent to form a contract is identified, and while one can find a basis for protecting the right to *earned* pension benefits under an implied contract for the payment of salary, a legal justification for protecting future accruals is lacking.

B. THE ECONOMIC INEFFICIENCIES AND INEFFECTIVENESS OF THE CALIFORNIA RULE

A significant shortcoming of the current California Rule is that it creates economic inefficiencies. As it currently stands, the California Rule locks in place one part of an employee's compensation package—future pension accruals. However, the employer has the ability to change cash compensation, fringe benefits, and employee tenure. As a result, if the accepted legal rule is that future pension accruals are nonnegotiable, employers and employees must negotiate based on other types of compensation. Furthermore, if a state needs to reduce its compensation expenditures (for example, to fund existing pension obligations), its available options are limited to reducing current salaries, scaling back or eliminating fringe benefits such as health insurance, or reducing the number of individuals it employs. The problem is that while other options are available, they may be less attractive to both parties. Assume, for example, that workers would be willing to trade a reduction in future pension accruals, from 3% of salary per year to 1% of salary per year, in exchange for retaining fringe benefits at their current levels and increasing cash compensation by 1%. Even though both parties might prefer this outcome, it would not be available; the state would need to retain pension accruals of 3% and achieve a 2% cost savings elsewhere.

Relatedly, it is important to recognize that the California Rule's protections are somewhat illusory. True, the state may not be able to change pension accruals to the detriment of current employees, but it can take plenty of other actions adverse to employees' financial interests. Employees and their representatives may be unwilling to negotiate on pension accruals because of their status as a protected right. However, in a time of fiscal contraction, failing to allow negotiation on prospective pension changes might very well lead to salary cuts, layoffs, hiring freezes, and reductions in other forms of fringe benefits. And such cuts may be less attractive to current employees, and potentially more damaging to the state, than solutions affecting future pension benefits.

C. THE REAL (HISTORICAL) PROBLEM—LONG VESTING PERIODS

This Article has argued that pension benefits that have already been earned through services rendered to the state should be protected against impairment, but that it is hard to find legal justification for protecting the rate of future benefit accruals. However, this seemingly straightforward approach to pension benefits ignores one critical issue—the vesting requirements historically used in many public pension plans. In general, in

order for a retirement plan to be a tax-qualified plan under § 401 of the Internal Revenue Code, it must comply with, among other things, minimum vesting requirements.³⁰⁶ For defined benefit plans, the minimum vesting requirements are either five-year cliff vesting (which means that a participant's accrued benefit becomes nonforfeitable after completing five years of service) or seven-year graduated vesting (where a participant's accrued benefit becomes 20% nonforfeitable after three years of service, with the nonforfeitable percentage increasing by 20% after each subsequent year of service, until 100% vesting is achieved after seven years of service).³⁰⁷ Governmental plans are, however, exempt from the normal vesting rules for qualified plans.³⁰⁸ Instead, the Internal Revenue Code only requires that accrued benefits fully vest upon a plan's termination.³⁰⁹ As a result of this exemption, public plans have historically had very long vesting periods, particularly in comparison to private-employer plans.³¹⁰

A long vesting period matters because it changes the future accrual analysis. Assume that individual *X* participates in a state pension plan that requires twenty years of service before vesting. Further assume that when the employee began work, she accrued pension benefits at the rate of 3% of salary per year. What if, ten years into *X*'s tenure with the state, the state announces that effective immediately, pension benefits will only accrue at the rate of 1% of salary per year? I have argued that such prospective changes should be permitted absent an explicit agreement protecting against such changes. If the employee does not like the offer, she is free to seek employment elsewhere. But note what that choice entails when the vesting period is long. *X* has earned a pension benefit equal to ten years of service multiplied by 3% of salary—a benefit that will replace nearly a third of her salary in retirement. However, if she does not want to accept the lower pension accrual rate, and would prefer to change employment to better satisfy her preferences, she must walk away from the pension benefit she has earned, because it will be forfeited under the plan's vesting requirements. And it is of course hard to imagine that *X* would be able to find new employment with a compensation level that would make up for losing a guaranteed annual payment of 30% of salary from age sixty-five through death. Under realistic assumptions, the only rational choice would

306. I.R.C. § 401 (2006) (amended 2008, 2010); *id.* § 411 (amended 2008).

307. I.R.C. § 411(a)(2)(A).

308. I.R.C. § 411(e)(1)(A).

309. *See* I.R.C. § 411(e).

310. *See, e.g.,* Kern v. City of Long Beach, 179 P.2d 799, 800 (Cal. 1947) (noting that the relevant plan required twenty years of service before a participant was entitled to a benefit). As of 2008, a majority of state retirement plans had five-year vesting requirements, although seventeen state plans did not vest participants until they had completed ten years of service. DANIEL SCHMIDT, WIS. LEGISLATIVE COUNCIL, 2008 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 20 (2010), available at http://legis.wisconsin.gov/lc/publications/crs/2008_retirement.pdf.

be to remain with the employer for another ten years, to achieve vesting under the pension plan, in order to avoid forfeiting an incredibly valuable benefit. When viewed in this light, it is easy to understand why a court might develop a method by which to protect future pension accruals.

Compare the situation just described to one in which a plan has only a five-year vesting requirement. In that situation, at the time the change in pension accruals is made, X is already fully vested. This means that if she no longer wishes to work for the state after it announces a reduction in the rate of pension accruals, she can make that decision without forfeiting the ten years of pension benefits she has already earned. The change appears to be more reasonable when it does not force a complete forfeiture of benefits or result in the employee having to continue to work for an employer for a lengthy period of time solely to hang on to benefits earned but not vested.

It is possible, of course, that even with a relatively short vesting period of five years, an employee facing a prospective pension change might be forced to accept a reduction in benefits to avoid forfeiting benefits that have already been earned. For example, if the employee in the example above had only worked for three years as of the date of the change, she would be forced to either forfeit an annual pension benefit worth 9% of her salary³¹¹ or continue to work under potentially undesirable terms for an additional two years before switching employers. The effect on employee decision making is much less significant than in the first example, but there remains a real possibility that accepting the lower pension accruals by remaining employed is a compelling choice.

The realities of long vesting periods certainly raise the possibility that some of the rule development discussed in this Article was driven not by a straightforward application of contract law, but rather by a desire to protect employees from a fundamental change in terms during an exceedingly long vesting period. The clearest example of this may very well be the *Kern* case, which involved an individual just thirty-two days shy of satisfying a twenty-year vesting requirement facing the complete elimination of the pension plan.³¹² However, long vesting periods are no longer the norm in California. In both of California's major public employee plans, members are vested after five years of service and are eligible to begin receiving benefits at either age fifty or fifty-five.³¹³ This may be reason enough for California courts to revisit prior holdings with respect to prospective pension changes. It might also suggest that if a state desires to make detrimental changes to a pension plan, it should at the same time immediately and fully vest all current participants in order to protect the benefits they have already earned

311. After three years of service, the employee's benefit would be 3% of salary multiplied by 3 years of service, or 9% of salary.

312. *Kern*, 179 P.2d at 800.

313. CAL. GOV'T CODE §§ 21060-61, 24201 (West 2003).

through service. Doing so would allow such employees to terminate employment without losing any earned pension benefits if they find the newly enacted pension provisions unattractive.

D. THE FIX?

The bad news for California is that the California Rule as announced in *Allen* has been law for over fifty years. And the more controversial holding of *Eu*—specifically protecting the right to future accruals—has been law for twenty years. As a result, stare decisis creates an uphill battle for anyone seeking to challenge the rule. With that said, this Article has shown that the rule was never based on a finding of legislative intent and therefore runs a high risk of improperly infringing on legislative authority. While the courts may be very hesitant to revisit this long-standing rule, particularly when state employees may have acted in reliance thereon, the failure of California courts to examine legislative intent may be significant enough to allow future courts to revisit and perhaps refine the California Rule.

In the other nine states that still follow the California Rule, convincing a state court to revisit some of the assumptions underlying the rule may be much easier, particularly because none of these states have ruled on the particular issue of future accruals. In Oregon and Colorado, this is precisely what the courts did. Rather than simply following past precedent regarding contract formation, the courts in Oregon and Colorado started with the correct first step in any legislative contract clause claim: an examination of whether there is clear and unambiguous intent to form a contract. Other states would be wise to do the same. The outcome of such examinations is unknown, but doing so is necessary to ensure that courts do not improperly infringe on legislative power. And it is perhaps helpful to remember that courts do not need legislative intent to create a contract to protect benefits that have already been earned. There is good authority for the position that such accrued benefits are protected by an implied-in-fact contract, not a legislatively created contract. In any event, courts in California and elsewhere owe it to their states' citizens to be much more explicit about the basis for finding that a contract exists, and should provide a more detailed account of what any such contract protects.

In addition to the legal hurdles associated with attempts to get state courts to reconsider the California Rule, there is also a significant political difficulty associated with such efforts. The only avenue for requesting that a court reconsider the California Rule is for the state to pass a law that infringes on the rights implicated by the California Rule. In other words, the state would have to find the political will to pass a law reducing the rate of future pension accruals for current employees in a situation where legislators are keenly aware that the state will be sued following passages and where the legal outcome of such a challenge is uncertain.

CONCLUSION

Hard policy choices need to be made with respect to the funding of many public pension plans in the coming years. Financial projections suggest that many state pension plans are significantly underfunded and will require sizable contributions from the state or its employees to maintain the plans at their current benefit levels. It may therefore be both necessary and advisable in some states to make changes to benefit structures. It is clear that earned benefits are entitled to a very high standard of legal protection. Such benefits can be changed only under a legitimate exercise of a state's police power—a difficult hurdle to clear. It is less clear, however, that future pension accruals should be entitled to the same level of protection. In some states, notably California, courts have ruled not only that retroactive reductions in pension benefits are impermissible but also that the state is prohibited from prospectively changing accrual rates for any current employees. This California Rule, adopted by many other states, improperly infringes on legislative power by holding that a legislative contract exists without ever evaluating whether there is clear and unambiguous evidence of legislative intent to form a contract. Even in the absence of a legislative contract, long-standing precedent protects earned pension benefits under the theory that earned compensation is protected by an implied contract, but there is no such basis for protecting future accruals absent an explicit agreement. Protecting such future accruals absent an explicit agreement to do so is inconsistent with contract theory, economically inefficient, and simply forces the state to make other changes to the terms and conditions of public employment that may be less desirable to employees, less effective at stabilizing public pension funds, and potentially more damaging to the state and its citizens. To the extent that courts continue to protect future accruals, they owe it to their states' citizens to clearly set out the legal basis on which such accruals are entitled to protection.