PUBLIC FINANCE

Kutak Rock Client Alert

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Services

Public Finance

Appellate Court Rules in Favor of City of San Jose in Pension Obligation Bond Validation Action

On April 29, 2024, the California Court of Appeal, Sixth Circuit, affirmed a Superior Court judgment in favor of the City of San Jose in connection with the City's effort to validate pension obligation bonds. The Court of Appeal agreed with the City's argument that the issuance of pension obligation bonds does **not** create a new indebtedness or liability for purposes of the California Constitutional debt limit. Instead, the Court of Appeal held that pension obligation bonds merely change the form of an existing indebtedness (pension obligations) from an obligation payable to the City's pension system to an obligation payable to bondholders.

Under California law, public agencies can obtain an expedited ruling as to the validity of certain actions and contracts by seeking a "validation judgment" from a court. In this case, the City of San Jose sought to validate a proposed issuance of bonds the proceeds of which would be applied to pay off all or a portion of the City's pension liability. The Howard Jarvis Taxpayers' Association challenged the City's validation effort, asserting that the issuance of pension obligation bonds constituted the creation of a new debt in violation of the Constitutional debt limit, which prohibits public agencies from incurring obligations in an amount that exceeds their current year income without voter approval. The trial court ruled in favor of the City, finding that, under the City's charter, it was required to provide pension benefits to City employees and therefore that the payment of such benefits was an "obligation imposed by law," which is an exception to the Constitutional debt limit.

The Taxpayers' Association appealed the trial court ruling, arguing that, because a pension liability amount changes as actuarial estimates and pension fund investment earnings (among other factors) change, and because the full pension liability is not due in one year, a pension liability is not a true debt. Under the Taxpayers' Association's argument, the City was attempting to replace an ever-changing pension liability that is not currently due and payable with bonds that would become payable in a fixed amount upon issuance. The Court of Appeal disagreed with the Taxpayers' Association's arguments and found that pension benefits are an element of public employee compensation which are earned as employees render services to public agencies, albeit compensation that is actually paid after employees retire.

Although the City is a charter city and its obligation to fund pension benefits arose out of provisions of its voter-approved charter, the Court of Appeal's reasoning did not rely heavily on these facts. Instead, the Court of Appeal found that public policy promotes pension benefits as a means of attracting and retaining qualified employees and that pension benefits are entitled to protection because they are part

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of public employees' compensation. This line of reasoning arguably applies equally to general law cities whose pension obligations arise pursuant to contracts with CalPERS.

Because the Court of Appeal held that changing the form of the City's pension liability from an obligation payable to the City's pension system to an obligation payable to bondholders would not create a new debt for purposes of the Constitutional debt limit, the Court of Appeal did not even reach the question of whether the "obligation imposed by law" exception to the Constitutional debt limit applied.

Kutak Rock LLP's Public Finance Group has served on numerous occasions as bond and disclosure counsel to public agencies throughout California and nationwide on pension obligation bond issuances. Please contact Cyrus Torabi in Kutak Rock's Irvine office for further information about the City of San Jose ruling or pension obligation bonds generally. You may also visit us at www.KutakRock.com.