From: Sen Boquist
Sent: Wednesday, March 27, 2013 8:14 AM
To: Sen Rosenbaum; Sen Ferrioli
Cc: Brocker Lori; Elzinga Stephen; Sen Knopp; Johnson Dexter
Subject: SB 822 PERS Legal Documents

Senator Rosenbaum & Senator Ferriolli:

Please enter into the OLIS Committee record for SB 822 this email and legal opinion in regard to PERS legalities.

It is my intention to provide additional documents for the committee record later today.

Sincerely,

Brian J. Boquist
Oregon State Senator
District 12

From: Jim Green [mailto:jgreen@osba.org]
Sent: Wednesday, March 13, 2013 11:35 AM
To: Sen Bates; Sen Olsen; Rep KenyGuyer; Rep Olson; Sen Roblan; Rep Unger; Sen Close; Sen Johnson; Rep Komp; Sen Hansell; Rep Kennemer; Rep Jenson; Rep Witt; Rep Barton; Sen Boquist; Rep Clem; Rep Hanna; Sen Starr B; Rep McKeown; Rep Tomei; Sen Shields; Sen Edwards C; Rep Garrett; Rep Gorsek; Rep Harker; Sen Thomsen; Rep Bentz; Rep Gomberg; Rep Boone; Rep Richardson; Sen Rosenbaum; Sen Whitsett; Sen Steiner Hayward; Sen Prozanski; Sen Girod; Rep Whitsett; Rep Whisnant; Sen Burdick; Rep Matthews; Rep Smith G; Sen Baertschiger; Sen Dingfelder; Sen Winters; Rep Conger; Rep Barker; Sen Kruse; Rep Reardon; Rep Williamson; Rep VegaPederson; Rep Thompson; Rep Weidner; Rep Gallegos; Rep Davis; Rep Huffman; Rep Lively; Rep Bailey; Rep Parrish; Rep Cameron; Rep Thatcher; Sen George L; Sen MonnesAnderson; Sen Beyer; Rep Frederick; Rep Doherty; Sen Hass; Rep Johnson; Rep Dembrow; Rep McLane; Rep Greenlick; Rep Nathanson; Rep Holvey; Rep Buckley; Sen Courtney; peter.defazio@mail.house.gov; Rep Barnhart; Sen Devlin; Sen Monroe; Rep Esquivel; Rep Gelser; Rep Fagan; Rep Sprenger; Sen Ferrioli; Rep Freeman; Sen Knopp; Rep Kotek; Rep Read; Rep Hoyle; Rep Gilliam; Rep Berger; Rep Hicks; Rep Krieger
Subject: OSBA PERS Modifications (SB 754) - Legal Analysis

Dear Legislator:

There has been a tremendous amount of discussion concerning the Public Employees Retirement System (PERS) and potential reforms or modifications to the system. The Governor has proposed a set of reforms, as have the Co-Chairs of Ways and Means through their budget development process. Several colleagues of yours have also put forward suggested modifications to PERS. The association that I represent, the Oregon School Boards Association (OSBA), working with several other partners has also put forward a plan (SB 754) that is generating numerous discussions.

A lot has been said about OSBA's proposal, but let me make it clear at the outset that SB 754 is not an attack on our hard-working, dedicated public employees. Our proposed legislation is a list of modifications to PERS that attempts to address the growing cost of an unsustainable system. Public employers are facing huge increases related to PERS coming this July if there is no action taken by the Legislature. For school districts alone the PERS rate will go from about 19% of payroll to almost 27% of

payroll. PERS' own actuary has indicated that these rates, over time, will continue to grow. School districts are facing even more difficult budget decisions this next school year and beyond if changes are not made.

One element of any discussion surrounding PERS modifications is whether the proposed changes will withstand a constitutional challenge. One thing is inevitable, if changes are made there will be a legal challenge, and the Oregon Supreme Court will need to review the legislation and determine whether it passes constitutional muster.

There have been a flurry legal opinions and arguments made from various lawyers on many of the proposed modifications. OSBA has sought a legal opinion on its proposed modifications. I am attaching a copy of the legal opinion we received related to our proposal. The analysis was conducted by Bill Gary of Harrang Long Gary Rudnick, P.C. Mr. Gary is a former Deputy Attorney General of Oregon, former Solicitor General of Oregon and has represented the interest of public employers in PERS litigation since 1999. Mr. Gary was the lead counsel in the *City of Eugene v. PERB,* and was also counsel in the litigation surrounding modifications made to PERS in 2003 and the cases that followed (Strunk, White and Arken). His knowledge and expertise related to Oregon's PERS is well established.

I would encourage you to review the attached opinion and analysis as it relates to OSBA's proposed modifications. Also, I would encourage you to contact me if you have any additional questions or concerns related to SB 754 or the attached analysis.

Thank you.

Jim Green
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March 11, 2013

Sent Via Email and First Class Mail
jgreen@osba.org

Jim Green
Deputy Executive Director
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1201 Court St NE, Ste 400
Salem, OR 97301

Re: Analysis of Concepts Proposed in SB 754 (2013)

Dear Jim:

You have asked us to provide a brief analysis of the legal viability of the concepts contained in SB 754 (2013), a bill that proposes several changes to the Oregon Public Employees Retirement System (PERS).

We conclude that each of the PERS reforms proposed in SB 754 is within the legislature's power to adopt and would neither breach nor impair the PERS contract. Because of the complexity of the issues presented by any modification to PERS and the virtual certainty that any enacted changes would be challenged in court, the specific means, structure and language by which those changes are enacted is critically important. As requested, we will provide specific recommendations concerning technical aspects of the draft bill in a subsequent communication.

1. The PERS Contract

The legal viability of the concepts proposed in SB 754 depends primarily on whether the changes to PERS proposed in that legislation would constitute a breach or impairment of the PERS "statutory contract." That depends upon whether the draft bill would repeal or modify any statute that is deemed to be a part of that contract.

Since at least 1993, the Oregon Supreme Court has consistently held that "PERS was intended to be and is a contract between the State and its employees." *Hughes v. State of Oregon*, 314 Or 1, 25, 838 P2d 1018 (1993). The terms of that contract are contained in the statutes that govern

PERS. Statements in employment handbooks, PERS publications, or rules or actions adopted or taken by the Public Employment Retirement Board (PERB) are not a part of the PERS contract. *Strunk v. PERB*, 338 Or 145, 175-76, 108 P3d 1058 (2005). However, not every statute dealing with PERS is a part of the PERS contract. *Id.* To determine whether a particular provision of the PERS statutes embody a contractual obligation, the court will examine the text, context, and legislative history of the provision to determine whether the legislature intended to make a contractual promise to PERS members that could not be changed by subsequent legislative action. *Id.* There is a strong presumption that the acts of one legislature cannot tie the hands of a subsequent legislature to enact or repeal laws as it deems appropriate. This presumption may not be easily overcome. The legislature's intention to make a binding statutory contractual promise must be unmistakably clear. The essential rule is as follows:

> "[L]egislative enactments may contain provisions which, when accepted as the basis of action by individuals, become contracts between them and the state. It is also equally well established that the intention of the Legislature thus to create contractual obligations, resulting in extinguishment to a certain extent of governmental powers, must clearly and unmistakably appear. The intention to surrender or suspend legislative control over matters vitally affecting the public welfare cannot be established by mere implication."

Id. at 171 (citing *Campbell et al. v. Aldrich et al.*, 159 Or 208, 213, 79 P2d 257 (1938). *See also Hughes*, 314 Or at 17 ("a contract will not be inferred from * * * legislation unless it unambiguously expresses an intention to create a contract").

Applying that standard, in reviewing the 2003 PERS reforms, the Oregon Supreme Court in *Strunk* concluded that some of the PERS statutory provisions it considered satisfied the standard and were therefore part of the statutory contract, but that other provisions did not satisfy the standard and were therefore not part of the statutory contract. The court concluded that the provisions of the PERS statutes that were not contractual could be modified by subsequent legislative act. Evaluating each statutory provision relating to PERS separately, to determine whether it reflected the requisite promissory intent, was a marked departure from the approach that the same court took in *Oregon State Police Officers' Association v. State of Oregon,* 323 Or 356, 918 P2d 765 (1996) (*OSPOA*).

In *OSPOA*,, the Oregon Supreme Court held that every provision of an amendment to the Oregon constitution, approved by the voters through the initiative process, unconstitutionally impaired the obligation of contract because they would have modified "integral terms of [the] plaintiffs' PERS pension contracts." 323 Or at 381. Although those "integral terms" were prescribed by statute, the *OSPOA* court did not analyze or discuss whether the legislature that

enacted those statutes intended to make a contractual promise that the content of those statutes would never change. Instead, the court simply concluded that "PERS constitutes an offer by the state to its employees for a unilateral contract that may be accepted by the tender of part performance by those employees...." *Id.* at 380. Using this "unilateral contract" analysis, the court concluded that every aspect of PERS "becomes vested in the state's employees on acceptance of employment." *Id.*

Under *OSPOA,* any subsequent change to PERS after an employee commences PERS covered employment would be deemed to be a breach or impairment of that employee's "unilateral contract." *Strunk* dramatically changed the analysis. Under *Strunk,* a statute affecting PERS is subject to change unless the legislature that adopted it "clearly and unmistakably" intended to make a contractual promise that the statute would not be changed. *Strunk,* 338 Or at 171. Each proposed change to the PERS statutes contained in SB 754 must be evaluated under that standard.

2. Limitation on Cost of Living Adjustment

SB 754 would change the way in which a retired member's service retirement allowance is adjusted to account for changes in the cost of living.

Currently, ORS 238.360(1) directs PERB to determine annually the percentage increase or decrease in the cost of living for the previous calendar year based on the Consumer Price Index. A retired PERS member's service retirement allowance is then subject to annual cost of living adjustments (COLAs), in the amount of the previous year's increase or decrease. Currently, ORS 238.360(2) provides that the annual increase or decrease in a member's service retirement allowance is capped at 2%.

When initially enacted in 1971, the statute governing COLAs (then numbered ORS 237.060) was substantially the same as the current statute. 1971 Or. Laws c.738 §11. However, it capped the annual increase or decrease at 1.5%. *Id.* Just two years later, in 1973, that cap was changed to 2%. 1973 Or. Laws c.695 §1.

SB 754 would again change the statutory cap, this time by limiting the amount to which the COLA may be applied. Retired PERS members would still be eligible for a COLA each year, but that increase would be applied to no more than a maximum monthly amount set by statute.

Whether that change affects the contract rights of PERS members depends on the extent to which the COLA provisions in ORS 238.360 are a part of the "statutory contract." That question was addressed, but not fully answered, by the Oregon Supreme Court in *Strunk.* In that case, the court held as follows:

> ORS 238.360(1), as it existed in 2001 and as presently worded, provides that PERS members' monthly service retirement allowances annually shall be adjusted to reflect 'the percentage increase or decrease in the cost of living for the previous calendar year[.]' [Thus,] the text of ORS 238.360(1) (2001) evinces a clear legislative intent to provide retired members with annual COLAs on their service retirement allowances, whenever the CPI warrants such COLAs. We therefore conclude that the general promise embodied in ORS 238.360(1) (2001) [is] part of the statutory PERS contract[.]

Strunk, 338 Or at 221. Stated more succinctly, "the general promise" to "provide retired members with annual COLA's on their service retirement allowances" cannot be breached or impaired by subsequent legislation. Thus, *Strunk* holds that the PERS statutory contract guarantees that every PERS retiree will be entitled to receive an annual COLA. However, *Strunk* does not hold that there is a statutory contractual promise to any particular amount of COLA. Nothing in *Strunk* says that the COLA cap contained in ORS 238.360(2) is not subject to change.

If the court in *Strunk* had considered the COLA cap in ORS 238.360(2), it likely would have concluded that it was not an immutable part of the PERS contract. First, there is nothing in the text or context of ORS 238.360(2) that indicates that the legislature in 1971 intended to make a promise that the cap would never change. Second, as noted, two years after the legislature adopted the COLA statute, it modified the cap, increasing it from 1.5% to 2%. Although 33 members of the House and 20 members of the Senate served in both the 1971 and 1973 legislative sessions,[1] there is no hint in the record of the 1973 amendment that anyone suggested that the change breached a promise that the COLA cap would never change. The fact that the legislature adjusted the cap in the legislative session immediately following its enactment and the fact that the cap provides a limit on both increases *and decreases* in service retirement allowances are strong evidence that the legislature did not intend for the amount of the cap to be carved in stone. A careful application of the statutory contract analysis in *Strunk* indicates that, although the legislature has made a statutory contractual promise to provide an annual COLA on all service retirement allowances, it has not promised that the annual cap on the COLA is immutable.

Thus, to the extent the proposed legislation changes only the *amount* by which COLA adjustments change a service retirement allowance, that change would not constitute a breach or impairment of the PERS contract.

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[1] http://arcweb.sos.state.or.us/pages/records/legislative/recordsguides/histleg/statehood/1973reg.html

3. Calculation of Final Average Salary

SB 754 would change the way a retiring PERS member's "final average salary" is calculated for purposes of determining the member's retirement allowance. Specifically, the proposed legislation would repeal ORS 238.350 and 238.355 (which provide, upon a public employer's request, a mechanism to credit accumulated unused sick leave toward final average salary) and exclude from the statutory definition of "salary" and "other advantages" both payments for overtime and payments for accumulated unused vacation leave. The changes would apply only to future retirees.

There is no existing provision in the PERS statutes that guarantees a member will be credited with accumulated vacation leave or overtime pay when final average salary is determined. Thus, the question whether a PERS member is contractually guaranteed a credit for accumulated vacation leave or overtime pay for purposes of final average salary depends first on whether payments for accumulated vacation leave or overtime pay are considered "salary" under the statutory definition of that term.

ORS 238.005 (26) (a) defines "salary" as "the remuneration paid an employee in cash out of the funds of a public employer in return for services to the employer, plus the monetary value, as determined by the Public Employees Retirement Board, of whatever * * * other advantages the employer furnishes the employee in return for services." In subsection (b), the definition goes on to specify certain types of remuneration that are specifically included in "salary," including payments into a deferred compensation plan and certain retroactive payments. In subsection (c), the definition specifies other types of remuneration that are specifically *excluded* from the definition of "salary". Exclusions include certain cash payments, such as travel expense reimbursement, accelerated payments and retirement severance pay.

Because the definition of "salary" does not specifically refer either to accumulated vacation leave or to overtime pay, those benefits can only be deemed to be an immutable part of the definition of "salary" if it is determined that the legislature intended to promise that all "remuneration paid to an employee in cash" and the value of all "other advantages the employer furnishes the employee in return for services" would forever be considered to be a part of "salary." But ORS 238.005 (26) (c) already *excludes* certain categories of cash remuneration from the definition of "salary." Absent a specific mention of overtime payments or vacation pay in the definition of "salary" it cannot be said that the legislature "clearly and unmistakably" intended to promise that overtime pay and vacation pay would forever be included in the definition of "salary". Therefore, a statutory change that precludes crediting a member with payments for accumulated vacation leave or overtime pay would not constitute a breach or impairment of the PERS statutory contract.

In contrast, the PERS statutes do provide for the crediting of accumulated sick leave toward final average salary – a benefit which SB 754 would end. In relevant part, ORS 238.350 requires that, upon a public employer's request, PERB "shall establish a procedure" for adding a portion of accumulated sick leave "and shall establish benefits of the retiring employee * * * reflecting that addition."

The question whether ORS 238.350 is itself a statutory promise was answered in the affirmative by the Oregon Supreme Court in *OSPOA*, which held that "[ORS 238.350] evince[s] a clear and unambiguous intention of the legislature for the state to become contractually obligated to plaintiffs [to allow crediting of sick leave] in the event that the [employer] request[s] participation in the sick leave credit program." 323 Or at 378. *OSPOA*, if upheld, would appear to preclude any change that prohibits crediting of sick leave in calculation of final average salary.

As noted above, however, *Strunk* significantly changed the contractual analysis employed in *OSPOA* and that case has been strongly criticized. *See, e.g., id.* at 408 (J. Gillette, dissenting) ("reject[ing] the analysis" that formed the basis of the majority's conclusion and its "entire approach to the problem," explaining that the majority "ignore[d] the rules that this court heretofore has set for itself in cases of this kind"); *Strunk*, 338 Or at 239 (J. Balmer, concurring) ("[T]he court in *OSPOA* lost sight of the polestar of statutory contractual analysis: clear, unambiguous, and unmistakable promissory intent."). Moreover, none of the members of the Supreme Court who participated in *OSPOA* remain on the court today. As a result, while a change to ORS 238.350 would invite a challenge on the grounds of breach or impairment of contract, we do not believe that the holding in *OSPOA* would be upheld or extended by the court today.

Without *OSPOA* to compel an answer, the question remains whether ORS 238.350 provides "clear" and "unmistakable" legislative intent to promise that PERS members will be entitled to a credit for unused sick leave in calculation of final average salary. The answer, we believe, is no. The plain language of ORS 238.350 does not guarantee that all PERS-eligible employees will be entitled to a credit for sick leave when their final average salary is calculated. Rather, the statute provides that, "*upon the request by a public employer*" that its employees be compensated for accumulated unused sick leave, PERB shall establish a procedure by which the employer may do so. In short, the statute is not a promise to benefit employees, it is an imposition on PERB to *allow an employer* the means to provide a benefit. As such, it falls short of the necessary showing to constitute a statutory contract under *Strunk*.

Justice Gillette's dissent in *OSPOA* -- which reflects the proper statutory-contract analysis far more closely than the majority in that case -- addressed an analogous question. In that case, *former* ORS 237.075 provided that an employer "may agree," if it wished, to pick up the 6 percent contribution that its employees would otherwise be required to pay, by paying it on their behalf. Petitioners in *OSPOA* argued that the statute constituted a contractual obligation,

such that legislation barring that "pick-up" would impair public employees' contractual rights. Justice Gillette rejected that argument, pointing out that the statute merely provided *permission* to an employer to confer a benefit, not a *promise* to the employee to receive one. *OSPOA*, 323 Or at 409 (J. Gillette, dissenting) ("Where, in the wording of that latter statute, is there any room for a plausible interpretation that transforms the aforementioned statutory *permission* into a *promise* to pick up all public employees' 6-percent contribution? Nowhere.") (emphasis in original).

As to ORS 238.350, the same distinction applies. Because the statute merely *permits* an employer to confer a benefit, rather than *promising* that employees will receive such benefit, it does not constitute part of the PERS contract between the legislature and public employees. As such, a repeal of ORS 238.350 should not constitute a breach or impairment of the PERS contract.

4. Taxation of Out-of-State Retirees

SB 754 provides that PERB will no longer pay increased retirement benefits to compensate for Oregon state income taxation of retirement benefits if the person receiving such benefits does not pay Oregon income tax on such benefits.

In short, this concept seeks to close a decades-old loophole, and does not constitute any breach or impairment of the PERS contract. Before 1991, the State of Oregon had taxed federal pension benefits as personal income, but exempted PERS retirement benefits from state taxation. In response to a U.S. Supreme Court decision holding that principles of intergovernmental tax immunity requires states to tax or exempt from tax both federal and state pension benefits alike, the legislature eliminated the tax exemption for PERS benefits. In 1992, the Oregon Supreme Court held that the legislature had contractually guaranteed to its employees that such PERS benefits would remain exempt from Oregon income taxation, and that its decision to subject PERS benefits to state tax therefore constituted an impermissible breach of the PERS contract. In response, the legislature, in 1991 and 1995, passed laws providing for increased PERS benefits in lieu of that tax exemption, as a remedy for the breach of its contractual promise to provide tax-free pension benefits. *See Stovall v. State of Oregon*, 324 Or 92, 922 P2d 646 (1996) (discussing history of the issue generally).

In 2011, the legislature refined its response to the problem by providing that, for those retiring on or after January 1, 2012, PERB may not pay the increase in retirement benefits provided by the 1995 law to a member whose benefits PERB knows are not subject to Oregon personal income tax. *See* ORS 238.372 *et seq*.

The concept proposed in SB 754 would further expand that response by providing that both the 1991 and 1995 increases shall not be paid to any member whose benefits are not subject to

Oregon income tax, and by widening the scope of the law to all retirees, not simply those retiring on or after 2012.

That concept does not constitute a breach or impairment of the PERS contract for the same reason the 2011 law did not do so. There is no indication of any "clear" and "unmistakable" intent on the legislature's part to make a statutory contractual promise that it would pay the 1991 and 1995 benefit increases to PERS retirees whose benefits are not subject to Oregon tax. To the contrary, the legislature indicated that such increases in benefits were enacted to offset the benefits that Oregon residents lost as a result of the legislature's 1991 decision to subject PERS benefits to Oregon income tax. Simply put, the legislature did not make a statutory contractual promise to compensate PERS retirees for taxes that they are not required to pay.

5. Transfer of Employee Contributions

SB 754 changes the accounts to which Tier 1 and 2 members' employee contributions are directed. Specifically, the concept contained in SB 754 would provide that Tier 1 and 2 members cease to be members of the Individual Account Program (IAP) for purposes of further contributions, and that PERB is to establish for each such member a new account into which employee contributions may be made, and from which PERB may draw money to pay the member's retirement benefits. The practical effect of this change is to end the membership of Tier 1 and 2 employees in the IAP and to direct future employee contributions into an account from which PERB will draw funds to pay a member's retirement benefits, rather than into an IAP account that is outside PERB's reach.

For decades, PERS members have been required to contribute, or to have employers contribute on their behalf, 6% of members' salaries toward their retirement. Prior to 2003, that employee contribution had been directed to the members' regular PERS accounts. *See former* ORS 238.200 (2001). In 2003, the legislature amended the PERS statutes to discontinue employee contributions to the PERS fund, instead directing employees' contributions to IAP accounts that were not subject to the assumed earnings rate, Money Match, or annual COLAs. As the legislative history of that statute makes clear, that amendment was intended as a means to reduce the costs of PERS by slowing the growth of the Money Match, not to establish a further benefit to employees.

Petitioners in *Strunk* challenged the 2003 law, contending that diversion of their employee contributions into the IAP accounts constituted "at a minimum, a breach of the contractual promise that all member contributions and earnings would be directed to and maintained in [the employee's] PERS member account." *Strunk*, 338 Or at 181.

The Oregon Supreme Court found no such promise in the PERS statutes. As the court explained, "[n]othing in the text of ORS 238.200(1)(a) (2001), which required PERS members to contribute

six percent of their salaries to the fund, supports petitioners' argument that the legislature intended that contribution to be immutable." *Id.* at 192. The PERS statutes, the court wrote, "do not establish clearly and unambiguously that the legislature intended to promise members that they could contribute six percent of their salaries to their regular accounts throughout their PERS membership so as to maximize their pension component calculation under the Money Match." *Id.* at 192-93.

Thus, *Strunk* appears to foreclose any impairment-of-contract challenge to SB 754 founded in the notion that PERS members are contractually guaranteed the right to make employee contributions and have them directed in a certain way.

In addition, to the extent a challenge to SB 754 is founded instead in the notion that Tier 1 and 2 members are contractually guaranteed to *remain* members of the IAP, we believe such challenge would be contrary to the language of the statute and contrary to its legislative history.

The statute governing employee contributions made by or on behalf of IAP members provides as follows:

> (1) A member of the individual account program must make employee contributions to the individual account program of six percent of the member's salary.
>
> (2) Employee contributions made by a member of the individual account program under this section shall be credited by the board to the employee account established for the member under ORS 238A.350(2).

ORS 238A.330. Under subsection (2) of that law, whether employee contributions "shall be credited to" an IAP account depends on whether such employee is "a member of the individual account program".

Membership of Tier 1 and 2 employees in the IAP is governed by ORS 238A.305(1), which provides that "all members of the Public Employees Retirement System who established membership in the Public Employees Retirement System before August 29, 2003, as described in ORS 238A.025 become members of the individual account program on January 1, 2004."

Thus, the statute does no more than establish the *commencement* of those employees' membership in the IAP. The statute shows no "clear" and "unmistakable" intent on the legislature's part to contractually guarantee those employees' membership in the IAP as an ongoing matter.

That is consistent with the fact that, as described above, the IAP statutes were enacted as a means to reduce the costs of PERS, not to confer an additional benefit on employees. The IAP amendments helped to manage the growing costs of PERS by diverting employee contributions away from the PERS fund into separate accounts that would not be subject to the assumed earnings rate, would not be eligible for COLAs, and would not be subject to doubling under the Money Match option. The rate of growth of individual member accounts would slow, and the number of PERS members eligible to retire under the more expensive Money Match option would fall. It was those goals the legislature sought to achieve by implementing the IAP; the legislature's intent was plainly *not* to confer an additional benefit on public employees.

6. Assumed Interest Rate for Calculation of Money Match

SB 754 would change the interest rate used to calculate a member's annuity for purposes of the "Money Match" option.

Currently, regardless of which formula is used to calculate a PERS member's service retirement allowance, a portion of that allowance is calculated by annuitizing the member's accumulated contributions and the interest thereon. By statute, that annuity must be "the actuarial equivalent" of the member's account. ORS 238.300. The annuity and the account are "actuarially equivalent" if both have the same present value. *Strunk*, 338 Or at 226, 233-34. Two elements, referred to as the "actuarial equivalency factors," are considered in determining an actuarially-equivalent annuity: expected mortality rates and an interest rate.

The use of inaccurate expected mortality rates in calculating benefits was the subject of one of the challenges in *Strunk*. Before 2003, PERB had generally used mortality tables that had been in effect since 1978 and were no longer accurate, as they understated the current life expectancy of PERS members. As a result, when the outdated mortality tables were used to convert a member's account balance to an annuity, the aggregate value of the annuity was greater than the value of the account balance—in other words, the present value of the account balance and the present value of the annuity were not actuarially equivalent. To remedy that discrepancy, the legislature in 2003 directed PERB instead to "use the best actuarial information on mortality available." The Oregon Supreme Court in *Strunk* upheld that change against an impairment-of-contract challenge, explaining that there was no contractual promise to have PERB apply "permanent" equivalency factors that were set in stone; rather, "the legislature intended for PERB to ensure that a retired member's stream of monthly payments would be the actuarial equivalent of that member's total service retirement allowance." *Id.* at 235. Thus, PERB must set both the mortality expectation and the interest rate "as necessary to produce actuarial equivalency in the calculation of members' service retirement allowances." *Id.* In short, to the extent there exists any "statutory contract" in this respect, the "contractual" aspect of the law is no more than the promise of actuarial equivalence.

Presently, the interest rate used by PERB to calculate a member's Money Match annuity is equivalent to the assumed earnings rate for the PERS fund, or 8%. Not only is the use of the fund's assumed earnings rate not required by statute, it is in fact *contrary* to the statute to the extent it produces an annuity that is worth more than the present value of the member's account. Under present economic conditions, that is exactly the result. Thus, the fix proposed under SB 754 – the use of a lower interest rate to calculate an actuarially-equivalent annuity – is legally viable for the same reason PERB's use of updated mortality tables was upheld in *Strunk*. PERS members have no contractual right to the ongoing use of an interest rate that results in annuitized benefits that exceed the present value of a member's account.[2] Therefore, the requirement that PERB apply an interest rate that results in actuarial equivalency should not constitute any breach or impairment of the PERS contract.

Yours very truly,

William F. Gary

WFG:smd

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[2] SB 754 would mandate that PERB use an interest rate of 4% in calculating a member's Money Match annuity. There is an alternative solution to the problem that may stand an even greater chance of withstanding legal challenge. Given the Oregon Supreme Court's guidance in *Strunk* that "the legislature's primary intent was to ensure that PERB *update the AEFs* as necessary to produce actuarial equivalency in the calculation of members' service retirement allowances," *id.* at 235 (emphasis added), it may be preferable to direct the legislature to periodically update the interest rate to comport with existing economic conditions. For example, an amendment might direct PERB to apply the same interest rates used by the federal government when determining the annuitized value of a present sum.