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MEETING DATE	**9/23/05**
AGENDA ITEM	**D.4.** Implementation

TO: Members of the PERS Board

FROM: Steven Patrick Rodeman, Administrator
Policy, Planning, & Legislative Analysis Division

SUBJECT: *City of Eugene* Decision and Implementation

OVERVIEW

- Subject: The Oregon Supreme Court issued its decision in the *City of Eugene* case on August 11, 2005. Resolution of that appeal triggered agency obligations under the court's earlier *Strunk* decision and the settlement agreement reached by the Board and Petitioners in the *Eugene* case ("Settlement Agreement"). This memo explores the policy decisions and options the PERS Board has to fulfill those obligations.
- Action: Provide policy direction to PERS staff on the issues identified below.
- Policy Issues:
  - What sources of funds does PERS have to meet its obligations under the Settlement Agreement?
  - How should PERS recover the funds needed to meet those obligations from the source(s) identified?
  - Should PERS exercise its waiver authority under ORS 238.715 for overpayments less than $50?
  - Should PERS attempt to recover interest on the overpaid amounts?

BACKGROUND

The *Eugene* case began in the Marion County Circuit Court as a challenge to the PERS Board's 1998 and 2000 employer rate orders for the petitioning employers and the Board's order allocating 1999 fund earnings. Several individual members then intervened in the suit. Judge Lipscomb entered a judgment in favor of the petitioning employers and the intervenors in several respects. PERS filed an appeal to that judgment and sought a stay in implementing it from both the Circuit Court and the Oregon Court of Appeals. Both courts denied granting a stay.

In the interim, the 2003 Oregon Legislature adopted PERS Reform Legislation that enacted into law many of the changes that would have been required to comply with Judge Lipscomb's judgment. That legislation was challenged by direct appeal to the Oregon Supreme Court (the *Strunk* case) and the *Eugene* appeal was also sent directly to the Oregon Supreme Court by legislative direction.

While the *Strunk* and *Eugene* cases were pending at the Oregon Supreme Court, the PERS Board entered into the Settlement Agreement with the petitioning employers in the

Eugene case. The Settlement Agreement resolved how PERS would fulfill its obligations under some elements of the PERS Reform Legislation and the *Eugene* case. Some of those obligations were contingent upon how the *Strunk* case was decided; others were fulfilled in accordance with the terms of the Agreement. The Board's actions in this regard have been challenged in a Multnomah County Circuit Court case, *White v. PERB*, which was put on hold pending resolution of the *Eugene* case, and is in the process of being revived.

PERS' OBLIGATIONS UNDER THE AGREEMENT

The *Strunk* decision triggered the following additional obligations under the Settlement Agreement:

1. Credit the Contingency Reserve with 7.5% of 1999 available earnings;
2. Fund the Gain/Loss Reserve up to the 30-month goal; and
3. Allocate 1999 earnings to Tier One member regular accounts at 11.33% (instead of the original 20%).[1]

Executing the last obligation does provide some of the funds needed to accomplish the first two. Additional funds to meet the obligations to the Contingency and Gain/Loss Reserves must be made available. Following the earnings crediting policy in effect at the time of the original crediting (March 2000) would result in the following steps:

1. Credit the Contingency Reserve up to $518.85 million. This number represents 7.5% of available 1999 earnings from Tier One member regular accounts, employer accounts, and the Benefits-in-Force Reserve ("BIF"). Staff does not recommend using 1999 earnings from Tier Two member regular accounts to fund the Contingency Reserve. The amount of 1999 Tier Two earnings that would be reallocated to the reserve would be *de minimis* (approx. $2 million) by comparison. Moreover, in the vast majority of cases, the Tier Two member account adjustment would be below the $50 threshold that the Board can waive recovery under ORS 238.715(6). Lastly, including Tier Two member regular accounts in the re-allocation of 1999 earnings, would significantly expand the administrative workload. An additional 95,500 accounts would need to be adjusted and 13,500 payments recovered (predominantly withdrawals and some retirements) if Tier Two accounts were included in the re-allocation.
2. Add an additional $2,054.68 million to the Gain/Loss Reserve. This would conform to the 2000 PERS Board's stated goal to fund that reserve with enough money to credit the assumed rate (8%) to Tier One regular member accounts, employer accounts, and the BIF for a period of 30 months of zero market returns. Again, following the earnings crediting policy in place at that time, earnings from Tier Two regular member accounts would not fund this reserve because they were not part of the annual rate guarantee nor protected from subsequent market losses.

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[1] As the Supreme Court noted in *Strunk*, "The legislature subsequently enacted the 2003 PERS legislation, Oregon Laws 2003, chapter 67, sections 9 and 10, *as amended by* Oregon Laws 2003, chapter 625, section 13, effectively codifying the 11.33 percent figure as the correct 1999 crediting decision."

3. Reduce allocated earnings to Tier One member regular accounts and related employer and BIF balances to an 11.33% earnings allocation, resulting in $2,573.53 million being available to credit to the Contingency and Gain/Loss Reserves as proposed above. Although the Settlement Agreement does not specify (or prohibit) the related employer and BIF balances to be adjusted to 11.33%, doing so would conform to the earnings crediting policy in place in 1999 and would be a consistent adjustment, garnering more of the funds needed to meet the first two obligations. As a practical matter, these earnings would be returned to their respective accounts when earnings are credited for 2000 and 2001 (the Gain/Loss Reserve would be fully liquidated in 2001), and brought forward consistent with the Board's earnings crediting policy in effect for those years.

ANALYSIS OF POLICY ISSUES

- ***What sources of funds does PERS have to meet its obligations under the Settlement Agreement?***

One source of funds will be adjustments to the regular accounts for existing Tier One members (active and inactive) to reflect a re-allocation of the 1999 earnings. Similarly, employer accounts and the BIF will be adjusted to reflect this re-allocation.

This 1999 re-allocation to existing Tier One member regular and employer accounts and the BIF will yield revised account balances that will then be brought forward consistent with the crediting decisions for intervening years. That means that the Gain/Loss Reserve will be liquidated as needed to credit 8% to Tier One member regular and employer accounts and the BIF for 2000, 2001, and 2002 (to the extent funds from that Reserve are available). As of year end 2002, employer accounts and the BIF will be adjusted to reflect pending losses that were allocated to those accounts and the Tier One Rate Guarantee Reserve will have a revised balance. For calendar year 2003, Tier One member regular accounts will receive 8% as required by the *Strunk* decision, while employer accounts and the BIF will receive their previously allocated shares of those earnings. Earnings for 2004 have not yet been allocated.

That brings us to the issue of recovering over-credited amounts with respect to Tier One members who no longer have existing accounts. Tier One members (and their beneficiaries or alternate payees, if any) who had regular accounts in 1999 and have retired, withdrawn, or died have received some form of distribution based on an account balance that was credited with 20% earnings for 1999. The actuary estimates the impact of that over-crediting to be about $800 million, including sums already paid out and amounts scheduled to be paid in future benefits. (see attachment)

In his Final Opinion and Order issued in October 2002, after remanding the 1999 earnings allocation order to the PERS Board, Judge Lipscomb said the following about recovering these amounts:

> The Board will also have to decide on remand how to administer the accounts of members who have retired since the 1999 earnings were originally allocated. Presumably, these employees retired upon PERS' representation that in doing so they would be entitled to a certain level of retirement benefits. It would not necessarily be legally permissible to simply readjust the benefits of the retired members since they have given up their public employment positions and changed their legal position by

> accepting one of the PERS' retirement options, **although there is some apparent statutory authority for doing so. See ORS 238.715.** (emphasis added) Accordingly, the Board should also consider other potential options, such as utilizing the Contingency Reserve provided for in ORS 238.670(1) or the Benefits-in-Force Reserve established in accordance with subsection (2) of ORS 238.670. The Board may also need to consider treating any funding shortfalls resulting from its recalculation of the employer contribution rates on remand as an administrative expense.[1] These are all decisions entrusted to the Board's discretion in the first instance by the legislature. See ORS 238.610.
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> [1] But cf. ORS 238.610(4).

The possible sources of recovery posited by Judge Lipscomb (retired members, reserves, and administrative expenses) will be discussed separately below. For each, staff will explore whether the option is legally permissible, fiscally prudent, and consistent with the Board's fiduciary obligations:

1. Administrative Expense. This option would involve charging the overpaid amounts that have already been paid and are to be paid in future benefits to retired Tier One members as an administrative expense, which would be recovered from future fund earnings.

Legal Analysis: Section 14b of HB 2003 (2003 Oregon Legislature) provides:

> (1) If the Public Employees Retirement Board is required to correct one or more of the erroneous benefit calculation methods identified in [the *Eugene* case], the board shall recover the cost of benefits erroneously paid to retired members as a result of those erroneous benefit calculations by one or both of the following methods:
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> (a) The board may withhold cost of living increases under ORS 238.360 from a retired member whose benefit is greater than the correctly calculated benefit of the member until such time as the member's benefit is equal to the correctly calculated benefit.
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> (b) The board may treat all or part of the present value of the benefits erroneously paid and payable to retired members as a result of the erroneous benefit calculations as an administrative expense of the Public Employees Retirement System, to be paid exclusively from future income of the Public Employees Retirement Fund, and to be amortized over an actuarially reasonable period not to exceed 15 years.
>
> (2) In no event may the cost of erroneous benefit calculation methods identified in *City of Eugene et al. v. State of Oregon* be considered an employer liability or charged to employers through employer contributions.

The cost of living adjustment ("COLA Freeze") method in (1)(a) above was found unconstitutional in the *Strunk* decision when applied under a different provision in the PERS Reform Legislation, leaving just the administrative expenses method in (1)(b).

An Oregon Attorney General opinion addressed to Senator Tony Corcoran dated June 3, 2003, stated, in relation to this provision, that charging the excess benefits received by certain PERS retirees against future earnings of the PERS Fund in the form of administrative expenses would "more likely than not" constitute a diversion of trust funds

prohibited by ORS 238.660. The analysis was based on trust law principles that place the burden of making a trust whole from excessive benefit payments on those who received such payment. Those principles further provide that assets of the trust are not liable for recovery of overpayments. The Attorney General noted that current PERS statutes are consistent with this analysis as they authorize the PERS Board in the first instance to recover excess payments from those who receive them (again, referring to ORS 238.715). While not officially released, the opinion has been summarized in newspaper articles and is available on the Internet.

Normally, retirement allowances may not be treated as administrative expenses.[2] Section 14b(1)(b) of HB 2003 (quoted above) attempts to modify this rule. Assuming that HB 2003 validly amended the PERS statute to allow treatment of the benefit overpayments as administrative expenses, as qualified by Section 14b(2) (also quoted above), the excess benefits payments would be chargeable solely to earnings that would otherwise be credited to the remaining member regular accounts. Thus, Tier One and Tier Two members with existing regular accounts would subsidize the retirement allowances received and to be received by the so-called "window retirees" (those retiring between April 1, 2000 and March 31, 2004). This would likely result in the benefits payable in the future to those Tier One and Tier Two members to be lower than they otherwise would be.

For example, assume earnings of $100 and normal administrative expenses of $10 and a charge for these special expenses at another $10. That would normally leave $80 in earnings to distribute. The restriction from section 14b(2), however, would require that employers receive earnings based on $90 to distribute, as these special administrative expenses cannot affect their distribution. That further reduces the balance of earnings available to distribute to member accounts to absorb what would otherwise be the employer's share of the special administrative expenses.

Fiscal Analysis: Charging these overpayments to administrative expenses necessarily puts the burden of repayment on current members. Not only would their accounts be adjusted for the 1999 earnings over-crediting, but their future earnings would be reduced to pay for the amounts overpaid to retired members because administrative expenses are charged first against available earnings in a calendar year and, if there are none, paid for by employers. Future earnings do not generally affect currently payable retirement, withdrawal, or death benefits, so the "window retirees" would receive the full benefit of the 1999 earnings over-crediting and not contribute to its recovery.

Fiduciary Obligation: Even if a court were to hold that treating the overpayments to the "window retirees" as an administrative expense is legal, placing the full burden of repaying approximately $800 million in over-crediting on those who did not (and will not) receive any benefit from it appears contrary to sound fiduciary practice, particularly when an available and legally permissible direct recovery method would more equitably align the burden with the benefit.

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[2] In the excerpt from Judge Lipscomb's opinion quoted above, he notes that recovering these funds from administrative expenses contradicts ORS 238.610(4), which specifies that amounts payable as allowances shall not for any purpose be deemed expenses of the Board.

2. Contingency and/or BIF Reserves. This option would involve transferring funds from the Contingency Reserve to the BIF to cover the costs of failing to adjust Tier One benefit payments, or to let the BIF absorb those additional costs by creating additional unfunded actuarial liability.

Legal Analysis: The Attorney General opinion to Tony Corcoran referenced above does not address the use of the Contingency or BIF Reserves. The opinion's reasoning applied to recovery from administrative expenses could, however, be similarly applied to these reserves. Using these reserves would subject assets of the trust to recovery of the overpayments, rather than looking to the trust's beneficiaries that received the benefit of the 1999 earnings over-crediting. Particularly, using the BIF would place the entire burden of repayment on the employers, as they are the only "swing" fund source when the BIF is under-funded. Unlike the administrative expense method, however, there is no statutory authority that would directly contradict or expressly authorize the use of the BIF or Contingency Reserve in this instance.

Fiscal Analysis: Some portion of the Contingency Reserve will undoubtedly be needed to cover the deficit created by the 1999 earnings over-crediting. Not everyone who received payments based on the original account balance will be found, much less be able or compelled to repay the excess benefit. The chief question is whether an additional portion of the Contingency Reserve should be used right now to cover the entire obligation of retired and withdrawn members before good-faith efforts have been made to recover directly from those who received the over-credited amounts. From a fiscal standpoint, this decision would shift the burden of repayment entirely to future earnings, as only they can be used to replenish the Contingency Reserve.

Fiduciary Obligation: The same principle described above about matching the source of repayment with its beneficiary would not be met if the Contingency or BIF Reserves were used to fund the entire remaining obligation. Using those reserves would leave certain retired and withdrawn members with a windfall while burdening current Tier One and Tier Two regular account members (actives and inactives) and employers with the obligation to repay the entire over-crediting (and without any corresponding benefit).

3. Direct Recovery. This option involves: (a) adjusting the future benefit payments made from Tier One member regular accounts to retired members, beneficiaries, or alternate payees that included the over-credited 1999 earnings; and (b) collecting the amounts already overpaid.

Legal Analysis: Tier One members who had regular accounts in 1999 have since then retired or withdrawn their regular accounts with the understanding that they would receive a certain level of benefits from that transaction, and they may have changed their position and circumstances based on that understanding. The fact remains, however, that representations as to benefit amounts were always made while a timely filed challenge to the 1999 earnings allocation order was pending. While the effect of that challenge was not and could not be known by PERS, much less by the retiring or withdrawing members, that pending court action nonetheless cast uncertainty on any transaction and signaled it may be subjected to some future adjustment depending on the outcome of that challenge.

The Settlement Agreement by its terms does not specify a method for (or prohibit PERS from) adjusting benefits for retired members; in fact, it leaves silent any obligation beyond re-crediting Tier One member regular accounts at 11.33% for 1999 earnings. The

issue of whether and how that re-crediting would affect individual members was not addressed in the Settlement Agreement or by the *Eugene* case. While neither the *Strunk* decision nor Judge Lipscomb's opinion reached a conclusion about whether and how the PERS Board may recover from retired members, both made direct reference to ORS 238.715, a statute which outlines the methods by which the Board is to recover overpayments or other improperly made payments.

That statute (copy attached) provides authority, direction and process for notifying members about, and recovering improperly made payments. Judge Lipscomb's decision, as it is now to be implemented under the Settlement Agreement, makes it clear that the allocation of 1999 earnings to Tier One member regular accounts in excess of 11.33% was improper. This conclusion was reinforced by the 2003 Oregon Legislative Assembly in its findings supporting the PERS Reform package (see the preamble to HB 2003 from that session). Under ORS 238.715, the Board has the authority to remedy that error.

The 2003 PERS Reform Legislation enacted a special, supplemental method of recouping overpayments from these recipients by instituting a COLA Freeze on a certain group of affected retired members, leaving other recipients unaffected by that method of recoupment (withdrawn accounts, double lump sum retirements, etc.). In *Strunk*, the Supreme Court invalidated the COLA Freeze as a recoupment method. An August 26, 2005 letter from Gregory A. Hartman to Paul Cleary (copy attached) argues that the Court's discussion of the COLA Freeze issue amounted to a holding that the Legislative Assembly determined that the higher allowance (referred to in the legislation as the "fixed" retirement allowance) was properly payable to the "window retirees" and cannot be adjusted.

As the response letter from Joseph Malkin to Mr. Hartman (copy attached) makes clear, the *Strunk* Court acknowledged that the legislature's intent was "to recoup what it deemed to be overpayments to the affected members' regular accounts in 1999." The Court's holding in *Strunk* was limited to finding the elimination of the COLA to be a breach of the PERS contract. The Court expressly stated, "Our conclusion that that particular legislative action amounted to a breach of the PERS contract, however, **implies nothing about PERB's – or, for that matter, the legislature's – authority to recover amounts determined to have been paid from the fund in error**" (emphasis added). The Court ended its discussion by saying, "The effect of our choice to declare that part of the law to be void is that petitioners will be returned – **at least for the time being** – to the same position in which they would have been if the legislature had not enacted the COLA suspension." (emphasis added).

Fiscal Analysis: Each affected person's benefit payment would need to be individually recalculated to determine the scope of the over-crediting under this recovery option. That effort (involving 43,000 benefit recipients) would be substantial, but it's the only way that we can accurately assess the impact of the improper crediting and related overpayment on each recipient. Staff is developing specific approaches to implement the *Strunk* and *Eugene* decisions; however, the range of approaches and related details are dependent upon the policy decisions outlined by this memo. Staff expects to return to the Board at a future meeting with a detailed implementation plan, including related staffing and budget requirements.

Developing a charge-off policy and identifying a source of funds will also be crucial for the direct recovery option. Some of the amounts over-credited will ultimately be determined to be uncollectable because the recipient cannot be found or does not have available assets to satisfy the claim. Those amounts must be recovered from elsewhere, possibly a charge against the Contingency Reserve.

Fiduciary Obligation: The direct recovery option comes closest to aligning the recovery of the amounts with those who received benefit from the overpayment. To adopt either of the first two options (charging all the over-credited amounts to administrative expenses or reserves) would hold retired or withdrawn members harmless and shift the burden to current members and employers.

STAFF RECOMMENDATION: Staff recommends adopting a policy that would pursue collection of the over-paid amounts from those who received direct benefit of the over-crediting. Charging that amount to administrative expenses has questionable legal authority and does not conform to sound fiscal or fiduciary principles as well as the direct recovery method does. Other methods of shifting the burden entirely to the shoulders of current members and employers raise similar fiscal and fiduciary concerns, at least until the option of direct recovery is exhausted.

- ***How should PERS recover the funds needed to meet those obligations from the source(s) identified?***

To establish the amount of an individual recipient's overpayment, the first step for PERS staff is to recalculate the monthly benefit the recipient should be receiving, based on the adjusted account balance reflecting the 1999 earnings re-allocation at 11.33%. This reduced benefit will next be compared to the benefit that the recipient has received and is projected to be paid up to a date certain (e.g., August 1, 2006). This calculation will yield the gross amount that the recipient has been overpaid

Next, the vast majority of these recipients were subjected to the COLA Freeze that was found to be unlawful under the *Strunk* decision. Those recipients are owed the amount of COLA they should have received had the freeze not been implemented. Again, that amount will be determined to a date certain and offset against the gross overpayment amount, yielding a net amount owed either by the recipient to PERS or vice versa.

If PERS owes more to the recipient to make up for the COLA Freeze than they were in fact overpaid, PERS will cut them a check and begin issuing the adjusted benefit as of the effective date of that adjustment. For recipients that end up owing PERS because the amount overpaid to them exceeds their COLA Freeze amount, a process must be instituted to collect the remaining overpaid amount.

ORS 238.715 provides the framework for proceeding to collect overpayments from the recipients. The first step would be to notify the affected recipients, describing the manner in which the recipient can appeal the Board's determination, the action the Board may take if the recipient does not respond, and the authority to assess interest, penalties, or costs of collection. This notice must be mailed to the recipient within at least six years of the overpayment or the Board loses its right to recovery, so staff expects to generate and send these notices no later than April 2006.

After receiving notice and exhausting any appeals they choose to pursue, assuming the agency's determination is upheld, recipients can work out repayment plans with PERS

staff to recover the balances owed. For recipients that are not receiving on-going payments, PERS staff will return to the Board for some collection parameters that refine the repayment plans available.

For members that continue to receive a monthly benefit, the statute and rules set a base-line that PERS could recover up to 10% of the monthly payment without the member's consent. Given the nature of this situation, however, staff proposes to follow a less aggressive repayment structure than the 10% reduction fully allowed under the statute.

ORS 238.715(1) provides two options for the Board to recover an overpayment: (a) reduce the monthly payment for a number of months or (b) reduce the monthly payment "by an amount actuarially determined to be adequate to recover the overpayment . . . during the period which the monthly payment will be made to the member. . .". In this second method, the reduction is actuarially determined and applied on a system-wide basis. Initially, any lump sum payment owed to the member from the COLA Freeze would be offset against the sum of overpaid benefits owed, as of a date certain. Then, for those recipients who still owe a balance to PERS, the actuary can calculate, based on the member's projected longevity and retirement option, how much their benefit needs to be reduced to repay the balance over the remaining stream of payments.

If PERS offered this option to recipients, their current benefit payment may be reduced when first adjusted but would then increase at the next (and subsequent) COLA date(s). From an actuarial standpoint, the payment adjustments would balance out on a system-wide level, so those recipients who outlived their mortality projections would contribute more than the actual overpayment, but that would be balanced out by those recipients who died early, leaving an unpaid balance.

Staff suggests that the recipient be able to choose this option in lieu of a lump sum payment. As to financial and fiduciary concerns, the main risk is that the actuarial assumptions used to calculate the payments do not hold up. This risk would be mitigated by using the most recently reviewed and approved actuarial assumptions at the time of the recalculation. Administratively, this option would relieve PERS of having to track exact repayment balances and transactions, limiting the time required to affect the recipient's payment to the one-time set up.

STAFF RECOMMENDATION: Staff endorses adopting an alternative payment structure other than the full 10% reduction allowed by statute. The Actuarial Adjustment option is more straightforward and extends the repayment over the longest period of time, minimizing the overall impact on the recipient. The adjustment only needs to occur at inception, but is also only accurate when implemented on a system-wide basis.

- ***Should PERS exercise its waiver authority under ORS 238.715(6) for overpayments less than $50?***

That statute allows the PERS Board to waive collecting an overpayment that is less than $50. Staff recommends the Board exercise that right for all overpayments below that amount in regard to the class of benefit recipients who no longer have existing PERS accounts (members, beneficiaries, or alternate payees who retired, withdrew, or are receiving a death benefit). The Board can provide further guidance on how those funds should be recovered, such as from the Contingency Reserve, when it addresses the

charge-off and collection policy that will be presented as part of the detailed implementation plan.

STAFF RECOMMENDATION: Staff recommend waiving the collection of overpayments of less than $50 from benefit recipients who no longer have existing PERS accounts.

- ***Should PERS attempt to recover interest or costs on the overpaid amounts?***

ORS 238.715(5) allows the Board to recover interest and costs on an overpaid benefit only when the system or a participating employer was not at fault. Here, the overpayment was caused by the allocation of 1999 earnings by the PERS Board at that time, so staff does not support charging interest or costs in recovering these amounts.

Even if other statutory bases could provide authority for charging interest, adding the element of interest would greatly complicate the fiscal administration of this recovery. Also, the recipients were not at fault in causing this overpayment, so there's no compelling fiduciary obligation to charge interest.

STAFF RECOMMENDATION: Staff recommend that recovery of the overpaid amounts not include interest or other costs.

COMMENTS AND CORRESPONDENCE

Numerous letters, e-mails, and telephone calls have been received by staff and the PERS Board regarding the Settlement Agreement since the *Eugene* decision was issued. Staff responded to all correspondence and posted a Frequently Asked Questions on the PERS website. Generally, these comments fell into four main categories.

The main categories of comment (in order of correspondence volume) are:

1. Comments that recalculating a benefit and requiring retirees to pay back the overpayment is unfair.

Retirees have expressed the opinion that recovering the overpayment to Tier One regular members based on 1999 earnings crediting is not fair and should not be paid by retirees. Many commented that they believe there is no legal basis to recoup the overpayment from retirees or adjust future benefits to correct for the over-crediting.

2. Retirees have asked how the recalculation of 1999 earnings crediting for Tier One regular members will affect their respective accounts and related benefit payment.

Retirees want to know if and how much they will have to repay and when guidelines and schedules for repayment will be in place.

3. Declarations that PERS has already determined how the Settlement Agreement will be implemented and demanding to know how and when that will be done.

A number of comments accused PERS of already having an implementation plan in place and withholding that information.

4. Suggestions on how to implement the Settlement Agreement.

PERS has received suggestions on how to implement the Settlement Agreement and potential sources to recoup the overpayment, including using current and future reserves, applying frozen COLAs, and spreading repayment over as much time as possible.

REVIEW AND APPEAL PROCESS

Before the Board directs staff to pursue direct recovery of the overpayments under ORS 238.715, some procedural requirements should be noted. The recipient must receive notice of the overpayment under ORS 238.715(4), and that notice must describe the manner in which the recipient can appeal the Board's determination. Generally, that appeal will be structured around the administrative appeal process. Staff will be coming to the Board at its retreat later this year with options for dealing with contested cases in general. Given the special nature of these cases, staff will include in that discussion some options to streamline and accelerate the appeal process to reach resolution of these cases as quickly as possible.

Note that whatever appeal process the Board describes in the notice will be the recipient's administrative appeal recourse. These overpayments will not trigger a notice of contest under ORS 238.450 unless the affected member had not already been sent a notice of entitlement.

SUMMARY OF STAFF RECOMMENDATIONS AND POLICY ISSUES

As noted earlier, PERS has three remaining obligations to execute now that the ***Strunk*** and ***Eugene*** cases have been resolved:

(1) Credit the Contingency Reserve with 7.5% of 1999 available earnings;

(2) Fund the Gain/Loss Reserve up to the 30-month goal; and

(3) Allocate 1999 earnings to Tier One member regular accounts at 11.33% (instead of the original 20%).

The remaining funds needed for the reserve transfers will come from re-allocating 1999 earnings to existing accounts (employer accounts and the BIF), but some action must be taken to recover amounts that have been and are scheduled to be paid to accounts that have moved into pay status (members, beneficiaries, or alternate payees who have retired, withdrawn, or are receiving a death benefit). These actions would include both recalculating an adjusted benefit going forward and recovering amounts that had already been overpaid as of the date of that adjustment.

Staff recommends that PERS recover those overpaid amounts from the recipients, using its Actuarial Adjustment and other authority under ORS 238.715 (unless the obligation is waived because it's under $50). Lastly, staff recommends that interest or other costs not be recovered on the overpaid amounts.

MERCER
Human Resource Consulting

Impact of Eugene Settlement

In our April 15 Board presentation, we estimated the impact of the Eugene settlement on PERS liabilities as of December 31, 2003. The following table reviews those estimates, breaking out the impact on benefits already in force.

	Post-Strunk Ruling	Impact of Eugene Settlement	Post Eugene Settlement
Actives Tier 1	$16.6	$(0.5)	$16.1
Actives Tier 2	$1.2	$0.0	$1.2
Judges	$0.1	$0.0	$0.1
Inactives	$4.5	$(0.3)	$4.2
Benefits in Force	$23.8	$(0.8)	$23.0
Total Accrued Liability	**$46.2**	**$(1.6)**	**$44.6**

The above estimates are based on the data, methods and assumptions used in the December 31, 2003 actuarial valuation, with modifications for valuing the Strunk ruling. In addition, the following assumptions have been incorporated to value the impact of the Eugene settlement:

- The Tier One interest credit for 1999 was reduced from 20.00% to 11.33%. We estimated this change to reduce Tier One active member account balances (post Strunk) as of December 31, 2003 by approximately 6.0%. This reduction is less than the immediate reduction would have been as of December 31, 1999 because it reflects the average impact of member contributions for 2000, 2001 and 2002.
- For these estimates, it is assumed that retirees who retired between April 1, 2000 and December 31, 2003, have their future benefits recalculated to reflect 1999 earnings crediting of 11.33% instead of 20.00%. The reduced benefit amount was previously estimated and provided to us by the prior actuary. We used this estimated benefit to value the impact of the Eugene settlement.
- We estimate the amount of benefits paid to retirees as of December 31, 2003 in excess of the benefit that would have been paid had 1999 earnings been credited at 11.33% to be approximately $75 million.
- Please note that all of these estimates are as of December 31, 2003 and do not reflect any retirements or changes in value after that date.

As you know, Mercer Human Resource Consulting is not a law firm and cannot render legal advice. The estimates provided above are not intended to imply any opinion as to the legality of reducing the liabilities, in particular for benefits in force, as described above.

238.715 Recovery of overpayments; rules.

(1) If the Public Employees Retirement Board determines that a member of the Public Employees Retirement System or any other person receiving a monthly payment from the Public Employees Retirement Fund has received any amount in excess of the amounts that the member or other person is entitled to under this chapter and ORS chapter 238A, the board may recover the overpayment or other improperly made payment by:

(a) Reducing the monthly payment to the member or other person for as many months as may be determined by the board to be necessary to recover the overpayment or other improperly made payment; or

(b) Reducing the monthly payment to the member or other person by an amount actuarially determined to be adequate to recover the overpayment or other improperly made payment during the period during which the monthly payment will be made to the member or other person.

(2)(a) Any person who receives a payment from the Public Employees Retirement Fund and who is not entitled to receive that payment, including a member of the system who receives an overpayment, holds the improperly made payment in trust subject to the board's recovery of that payment under this section or by a civil action or other proceeding.

(b) The board may recover an improperly made payment in the manner provided by subsection (1) of this section from any person who receives an improperly made payment from the fund and who subsequently becomes entitled to receive a monthly payment from the fund.

(c) The board may recover an improperly made payment by reducing any lump sum payment in the amount necessary to recover the improperly made payment if a person who receives an improperly made payment from the fund subsequently becomes entitled to receive a lump sum payment from the fund.

(3) Unless the member or other person receiving a monthly payment from the fund authorizes a greater reduction, the board may not reduce the monthly payment made to a member or other person under the provisions of subsection (1) of this section by an amount that is equal to more than 10 percent of the monthly payment.

(4) Before reducing a benefit to recover an overpayment or erroneous payment, or pursuing any other collection action under this section, the board shall give notice of the overpayment or erroneous payment to the person who received the payment. The notice shall describe the manner in which the person who received the payment may appeal the board's determination that an overpayment or erroneous payment was made, the action the board may take if the person does not respond to the notice and the authority of the board to assess interest, penalties or costs of collection.

(5) If the board determines that an overpayment or erroneous payment was not caused by the system or by a participating public employer, the board may assess interest in an amount equal to one percent per month on the balance of the improperly made payment until the payment is fully recovered. The board may also assess to the member or other person all costs incurred by the system in recovering the payment, including attorney fees. Interest and costs may be collected in the manner prescribed in subsections (1) and (2) of this section. The board may waive the interest and costs on an overpayment or other improperly made payment for good cause shown.

(6) Notwithstanding ORS 293.240, the board may waive the recovery of any payment or payments made to a person who was not entitled to receive the payment or payments if the total amount of the overpayment or other improperly made payments is less than $50.

(7) A payment made to a person from the fund may not be recovered by the board unless within six years after the date that the payment was made the board has commenced proceedings to recover the payment. For the purposes of subsection (1) of this section, the board shall be considered to have commenced proceedings to recover the payment upon mailing of notice to the person receiving a monthly payment that the board has determined that an overpayment or other improperly made payment has been made.

(8) The remedies authorized under this section are supplemental to any other remedies that may be available to the board for recovery of amounts incorrectly paid from the fund to members of the system or other persons.

(9) The board shall adopt rules establishing the procedures to be followed by the board in recovering overpayments and erroneous payments under this section. [Formerly 237.312; 2003 c.105 §6; 2003 c.733 §66]

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BY FAX AND MAIL: 503-598-0561

Paul Cleary
Executive Director
Public Employees Retirement System
PO Box 23700
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Re: Implementation of 1999 Earnings Recalculation for Retirees
Our File No. 5415-260

Dear Paul:

I understand with the dismissal of the appeal in the *City of Eugene* case that the PERS board intends at its upcoming September 23 meeting to take action on issues relating to the redistribution of 1999 income. Although your website makes it clear that no particular plan of action has, as yet, been adopted, it also contains information showing the potential for substantial cutbacks for current retirees as well as potential invoices for overpayment. The purpose of this letter, which I am sending on behalf of the PERS Coalition, is to point out that any action by the PERS board to reduce the benefits of so-called window retirees (April 2000 through April 2004) would be inconsistent with the analysis of the Supreme Court in the *Strunk* case. This letter is limited to reviewing the rights of the window retirees as articulated in the *Strunk* case; it is not meant to address the rights of other retirees or non-retired PERS members. We continue to study issues relating to those members and will communicate our thoughts to the board at the appropriate time.

Prior to reviewing *Strunk* it is important to note that nothing in Judge Lipscomb's judgment compels the PERS board to take any specific action in regard to PERS retirees. In his opinion Judge Lipscomb acknowledged the existence of ORS 238.715 but nonetheless expressed great concern about whether it would be legally permissible for the PERS board to attempt to modify the benefits of PERS retirees. In addition there is nothing in the Settlement Agreement between *City of Eugene* plaintiffs and the PERS board which

requires the PERS board to take any particular action in regard to retirees. The failure of the Settlement Agreement to reference any change in retiree benefits leads to the logical conclusion that the parties agreed to settle the *City of Eugene* litigation on the basis of the remedies set out in the Agreement and that no further action was contemplated. However, as discussed below, it is not necessary for the board to review either Judge Lipscomb's opinion or its own Settlement Agreement as the rights of the window retirees were defined by the 2003 legislature as explained in the majority opinion in *Strunk*.

In *Strunk* petitioners argued that the 2003 legislative enactment which took away COLA increases from window retirees was either a breach or an impairment of the individual members' contract rights. 338 Or at 218-219. In response the major argument made by the respondents was that no contract rights could adhere to benefits which were based on an improper crediting to members' individual accounts. *Id.* at 219. In support of that position the respondents referenced ORS 238.715, which they argued gave the PERS board a broad right to recover benefits based on over-crediting. *Id.*

After first holding that the COLA promise contained in ORS 238.360 was contractual, the court went on to hold, after citing ORS 238.715, that the COLA promise does not extend to erroneous overpayments included in a member's service retirement allowance that the member was not entitled to receive. 338 Or at 222. However the court then pointed out that ORS 238.715 had no application to the window retirees as the legislature itself had determined a new "fixed" service retirement allowance for these particular retirees. *Id.* at 223. Since this new "fixed" retirement allowance was determined by the legislature, no argument could be made that this was a retirement allowance to which the member was not entitled. *Id.* Put another way, once the legislature had provided for this new "fixed" retirement allowance, ORS 238.715 had no relevance. The court went on to hold that this new "fixed" service retirement allowance as determined by the legislature came within the scope of the COLA promise and therefore window retirees were entitled not only to the "fixed" service retirement but any COLA which would have attached to that retirement benefit. *Id.* As a result the court declared void the language in the statute which said that COLA would not be applied to the new fixed service retirement allowance. *Id.* at 225.

As the PERS board deals with the issue of the appropriate steps to take in regard to window retirees, it should be clear that any action the board takes must be consistent with this "fixed" retirement allowance granted to window retirees. The only action available to the board is the continuation of the "fixed" service retirement amount and, in addition, whatever COLA increases should have been paid. It should be clear that ORS 238.715 cannot be applied to the window retirees, given the analysis in the *Strunk* opinion. As pointed out above, there is nothing in either the Lipscomb judgment or the Settlement Agreement which would lead to a contrary conclusion. Most importantly, even if there were language in either the Lipscomb judgment or alternatively in the Settlement Agreement requiring some other course of action, the PERS board is required to follow the mandate of the 2003 legislature as interpreted by the *Strunk* court.

After you've had a chance to review this material if you should have any additional questions or require any additional information from our office, do not hesitate to contact me.

Yours very truly,

Gregory A. Hartman

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cc: Clients (email only)
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September 12, 2005

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Re: Implementation of 1999 Earnings Recalculation for Retirees

Dear Greg:

As counsel to the Public Employees Retirement Board ("PERB" or the "Board"), we are responding to your August 26, 2005 letter to Paul Cleary concerning the implementation of the 1999 earnings recalculation for retirees.

First, you point out that neither Judge Lipscomb's judgment in *City of Eugene* nor the Settlement Agreement in that case requires PERB to take any particular action with respect to retirees. From this you assert that the "logical conclusion" is that "the parties agreed to settle the *City of Eugene* litigation on the basis of the remedies set out in the Agreement and that no further action was contemplated." Your conclusion is not logical, however. Judge Lipscomb held in *City of Eugene* that the prior board had abused its discretion by crediting 20 percent earnings to Tier One member accounts in 1999 instead of properly funding the Contingency Reserve and the Gain-Loss Reserve. The Legislative Assembly codified Judge Lipscomb's conclusion that Tier One member accounts should have been credited with 11.33 percent earnings. Oregon Laws 2003, chapter 67, sections 9 & 10, *as amended by* Oregon Laws 2003, chapter 625, section 13. As the Supreme Court pointed out in *Strunk*, the failure of the prior boards to fully fund the reserves created a "funding gap." The Board must take some action to close this funding gap.

You next argue (and this is the principal thrust of your letter) that the Supreme Court's *Strunk* decision holds that "once the legislature had provided for [the] new 'fixed' service retirement allowance, ORS 238.715 [addressing recovery of overpayments] had no relevance." We disagree with your conclusion and believe that you are reading more into the Court's discussion of the COLA issue than the Court intended.

In *Strunk*, the Supreme Court invalidated the COLA freeze as a recoupment method for the overpayments flowing from the erroneous 1999 earnings crediting. The *Strunk* Court acknowledged that the legislature's intent was "to recoup what it deemed to be overpayments to the affected members' regular accounts in 1999." The Court's holding in *Strunk* was limited to concluding that Tier One members are entitled to COLA on any retirement allowance provided for under PERS and that the elimination of the COLA constituted a breach of the PERS contract. The Court expressly stated, "Our conclusion that that particular legislative action amounted to a breach of the PERS contract, however, **implies nothing about PERB's – or, for that matter, the legislature's – authority to recover amounts determined to have been paid from the fund in error**." (emphasis added) The Court ended its discussion by saying, "The effect of our choice to declare that part of the law to be void is that petitioners will be returned – **at least for the time being** – to the same position in which they would have been if the legislature had not enacted the COLA suspension." (emphasis added) Had the Court intended to preclude the application of ORS 238.715 or legislative enactments other than the COLA freeze, it would not have included these statements.

Thus, we believe the *Strunk* Court expressly reserved to the Board and/or the Legislative Assembly the determinations of whether the "fixed" retirement benefit, which was nothing more than the pre-existing overpayment based on the erroneous 1999 earnings crediting, had been paid from the PERS fund in error and whether PERS should take some action to recovery the erroneous payments from those who received them. Given Judge Lipscomb's ruling that a prior PERS board had abused its discretion when it credited 20% to Tier One member regular accounts for 1999, the legislature's codification of 11.33% as the appropriate earnings crediting rate for that period, and the Settlement Agreement's direction to reallocate those earnings, we conclude that the Board's ability to spread the impact of that reallocation across all affected groups, including retired members, to the extent reasonably available, is not restricted by the Supreme Court's decision.

Sincerely yours,

Joseph M. Malkin

JMM/mj

cc: Paul Cleary