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CONFIDENTIAL AND ATTORNEY-CLIENT PRIVILEGED

June 3, 2003

Senator Tony Corcoran
State Capitol, S-319
900 Court Street, NE
Salem, Oregon 97301

RE: HB 2003 and HB 2004

Dear Senator Corcoran:

Enrolled HB 2003 (HB 2003) and Enrolled HB 2004 (HB 2004), would change the Public Employees Retirement System (PERS). You asked four questions about the constitutionality of certain elements of these measures.[1] We previously provided oral answers. Now, at your request, we provide written answers.

To answer your questions, we must anticipate potential challenges and predict the judicial resolution of them. We have set out below your questions followed in each instance by a summary of the result that we believe the courts most likely would reach. In the detailed answers, we explain our conclusions and discuss other potential outcomes that we believe are possible but less likely. We refer throughout this opinion to the Oregon Supreme Court's two most salient decisions about PERS: *OSPOA v. State*, 323 Or 356, 918 P2d 765 (1996), and *Hughes v. State of Oregon*, 314 Or 1, 838 P2d 1018 (1992).

FIRST QUESTION PRESENTED

Part A. Does the 'look back' provision of HB 2004 adequately protect PERS members' contract rights?

Part B. Does the 'look back' provision of HB 2004 ensure the continued qualification of the PERS plan under the federal Internal Revenue Code?

ANSWER

Part A. No. The appellate courts will likely hold that the legislature may require the PERS Board (PERB or Board) to apply new actuarial factors only to retirement benefits that a PERS member may accrue in the future for work performed after the effective date of HB 2004. OAR 459-005-0055, to the extent that it provides for the application of existing actuarial factors to retirement benefits accrued for work already performed and for benefit payments to be calculated based on all segments of work performed until the date of retirement, is part of the PERS contract. To the extent that Section 4 (the "look back" provision) of HB 2004 impairs these contractual provisions, it does not adequately protect the contract rights of persons who perform work as public employees prior to the effective date of HB 2004. Our detailed discussion of these conclusions begins on page 9.

Part B. The Internal Revenue Code (IRC) requires that a tax qualified defined benefit pension plan like PERS provide "definitely determinable" benefits. Whether HB 2004 would disqualify the plan is uncertain. To eliminate uncertainty about the meaning and applicability of the "definitely determinable" requirement, PERS should seek a determination from the IRS about the plan's status in light of the changes to OAR 459-005-0055 caused by HB 2004. Our detailed discussion begins on page 24.

SECOND QUESTION PRESENTED

Does HB 2003's cessation of employee contributions to the PERS plan, and the consequent lowering and eventual elimination of the money match benefit, constitute a breach or impairment of PERS members' contract rights?

ANSWER

Yes. Based on the Supreme Court's decision in *OSPOA*, Oregon appellate courts will likely hold that HB 2003's cessation of employee contributions to the PERS plan constitutes an impairment of some PERS members' contract rights. If the Supreme Court ultimately rejects the majority opinion in *OSPOA* and relies instead on its previous decision in *Hughes*, employee contributions could be terminated for current PERS members as to work performed after the effective date of HB 2003. Our detailed discussion of these conclusions begins on page 25.

THIRD QUESTION PRESENTED

ORS 238.255 provides that each year the accounts of PERS members who joined the system before January 1, 1996 are entitled to be credited in an amount no less than the amount of the system's assumed interest rate for that year ("the guaranteed rate for Tier One accounts"). Does HB 2003 eliminate, lower or alter the guaranteed rate for Tier One

accounts, and, if so, does that constitute either a breach or impairment of the contract rights of affected PERS members?

ANSWER

Yes. HB 2003 effectively lowers the guaranteed rate for Tier One accounts. Based on the Supreme Court's decision in *OSPOA*, Oregon appellate courts will likely hold that any change in the guaranteed rate for Tier One account balances (contributions and accrued earnings) arising from work performed either before or after a change is an unconstitutional impairment of contract rights. If the Supreme Court ultimately rejects the majority opinion in *OSPOA* and relies instead on its previous decision in *Hughes,* a change in the guaranteed rate for Tier One account balances could be made for account balance amounts generated by work performed after the effective date of the change. Our detailed discussion of these conclusions begins on page 33.

FOURTH QUESTION PRESENTED

Part A. Do the provisions in HB 2003 that shield public employers from the effects of the Board actions held unlawful in Marion County Circuit Case Nos. 99C-12794, 00C-16173, 99C-12838 and 99C-20235, by charging the costs of those actions to future Public Employees Retirement Fund (PERF) earnings as an "administrative expense," breach or impair the contract rights of PERS members otherwise unaffected by the disputed Board actions?

Part B. Does the answer vary for Tier One and Tier Two employees because only Tier One employees are guaranteed the assumed interest rate?

ANSWER

Part A. Yes. The appellate courts will likely find that shifting the cost of overpayments from the recipients to other PERS members would breach the latter's contract rights. Our detailed discussion of these conclusions begins on page 36.

Part B. Our answer does not depend on whether an affected member is Tier One or Two.

DISCUSSION
THE PERS CONTRACT

A. The Judicial Framework for Analysis of the PERS Contract and Its Terms.

Both the Oregon Constitution and the United States Constitution prohibit the state from passing any law "impairing the obligations of contracts." Or. Const. Art. I,

Section 21; U.S. Const., Art. I, Section 10. These prohibitions apply to contracts to which the state is a party and to contracts between private parties. *Eckles v. State*, 306 Or 380, 390, 760 P2d 846 (1988).

The Oregon Supreme Court has consistently recognized that PERS creates a contract between the state and public employees who are PERS members.[2] The Oregon Supreme Court has repeatedly stated that "PERS is a contract between the state and its employees, and that public employment gives rise to certain contractual obligations that are protected by the state and federal constitutions."[3] *OSPOA*, 323 Or at 370, *citing Hughes*, 314 Or at 17-21. In *Hughes* the court held that a statute comprising part of PERS was an offer "by the state to its employees, for a unilateral contract" which an employee accepts through performing work for the state. *Hughes*, 314 Or at 20-21. As stated in *Hughes* and reiterated in all three of the court's opinions in *OSPOA*,[4] an employee's contractual right to specified pension benefits "becomes vested at the time of his or her acceptance of employment * * * * [and] [o]n vesting, an employee's contractual interest in a pension plan may not be substantially impaired by subsequent legislation." *Hughes*, 314 Or at 20; *see also OSPOA,* 323 Or at 371 (majority opinion), at 385 (Fadeley, J., concurring), and at 407 (Gillette, J., Carson, C.J, and Graber, J., specially concurring and dissenting).

Both *OSPOA* and *Hughes* recognize that "the state may undertake binding contractual obligations with its employees, including [for] benefits that may accrue in the future for work not yet performed." *OSPOA*, 323 Or at 371; *see also Hughes,* 314 Or at 28. Both also recognize that a public employee accepts the unilateral contract offer of PERS by tendering part performance through his or her work. *OSPOA*, 323 Or at 375-376; *Hughes,* 314 Or at 20–21. These conclusions are consistent with a series of cases dating back to 1940 in which the court held that a public employer could not: (1) reduce the amount of a teacher's annuity after she had retired, *Crawford v. Teacher's Ret. Fund Ass'n,* 164 Or 77, 99 P2d 729 (1940); (2) eliminate a cash payment for unused sick leave at retirement with respect to work already performed, *Harryman v. Roseburg Rural Fire Prot. District,* 244 Or 631, 420 P2d 831, *rev den* (1971); (3) cease crediting temporary service to the period of service needed for retirement after it had been performed, *Adams v. Schrunk,* 6 Or App 580, 488 P2d 831, *rev den* (1970); or (4) remove members from PERS by changing the coverage criteria, *Taylor v. Mult. Co. Dep. Sher. Ret. Bd.,* 265 Or 445, 510 P2d 339 (1973). The common element in all of those decisions is that the Court has consistently held that statutes or ordinances that are part of the benefit calculation are part of the pension contract – *i.e.* statutes that determine: the amount of benefits, whether directly or indirectly (guaranteed interest rate); the value of benefits (tax exemption); who is eligible to receive benefits; or when a member is eligible to receive benefits.

These statements, however, do not provide all that is needed to explain the court's decisions in *OSPOA* and *Hughes*. Further examination of these opinions is required to

understand how the court arrived at its conclusions about the existence and scope of contractual rights in PERS.

At the outset, we recognize that the court's analysis of the PERS contract creates tension between the contract theory of public pension rights, as protected from impairment by the Oregon Constitution and the United States Constitution, and the general proposition that one Legislative Assembly may not bind its successors. The state argued in *Hughes* that recognizing a contractual right to apply current rules to the calculation of benefits for work yet to be performed could conflict with state constitutional prohibitions against incurring debts or liabilities that require future appropriations. Appellant's Brief at 28-32. Nevertheless, in *Hughes* the court held that "if the appropriate contractual conditions are met, one legislature may bind a succeeding legislature to a particular course of action." *Hughes,* 314 Or at 13. And, in rejecting the state's argument in *Hughes* that the state's power to revoke a tax exemption could not be limited by contract, the court wrote:

> "If the legislature creates a statutory contract, regardless of subject matter, it limits its sovereign power in some respect. That limit – for good or ill -- is part of the substance of the guarantee embodied in the Contract Clause.

Hughes, 314 Or at 17, fn 21.

Because it is the most recent exposition of the court's methodology for determining contract rights as to PERS, our analysis might ordinarily begin and end with *OSPOA*. The Oregon Supreme Court, however, was deeply divided in *OSPOA*. In *OSPOA*, members of the court wrote three opinions. And all three opinions purported to rely upon *Hughes* and its predecessors.

Furthermore, there are arguable distinctions between the analysis employed by the court in *Hughes*, and the analysis used by the majority in *OSPOA* to determine whether a statute is part of the PERS contract. *Hughes* and the majority in *OSPOA* differ in the analysis used to determine the PERS benefits to which the contractual obligation applies. Stated another way, the cases appear to differ in their approach to determining whether a statute creates a contractual obligation and, if it does, whether that obligation controls not only how the state treats benefits that an employee has accrued by work already performed but also controls the treatment of benefits an employee may accrue in the future by work not yet performed. Consequently, we address in some detail the differences we perceive in the court's decisions in *Hughes* and *OSPOA*. Where relevant, we also identify how our answers would differ, if at all, as a result of employing one analytical framework as opposed to the other.

To determine the constitutionality of a statute, ballot measure or other law that changes terms of the PERS pension plan as it then exists, the court's decisions require that we answer three questions: (1) Is the affected term(s) part of the PERS statutory contract? (2) If it is, what are the terms of the promise? (3) Does the conflict between the new law and the PERS contract constitute an impairment or merely a breach of the contract? *See Hughes,* 314 Or at 22-33. *Hughes* addressed whether statutory amendments purporting to tax benefit amounts received by PERS members or other beneficiaries impaired or breached the PERS contract.

The court first determined that the existing statute exempting PERS benefit payments from taxation was part of the PERS contract. *Hughes*, 314 Or at 27. The court's primary consideration in making this determination was the context in which the statute had been adopted. *Id.* at 25. Noting that the exemption statute "was enacted as part and parcel of the Public Employees' Retirement Act of 1953," *id.*, the court examined both "the context and purpose of the entire PERS contract" in concluding that the particular statute was part of the contract. *Id.* The court concluded "that the context in which the tax statute is enacted is of primary importance." *Id*

The court then went on to note that the text of the exemption statute lent further support to its determination that the statute was a part of the PERS contract because on its face the statute "unambiguously evince[d] an underlying promissory, contractual legislative intent." *Id.* at 26. However, unambiguous textual support in the statute was not essential. In rejecting the dissent's argument that the exemption statute did not express contractual intent, the majority in *Hughes* wrote:

> Also significant is that in those cases [from other jurisdictions where contractual rights to tax exemptions were found to exist] the tax exemption terms are not, on their face, indicative of an intention not to repeal those exemptions. The constitutional protection that was afforded to those provision's obligations followed from the fact that they were part of a larger contract, not that they were promissory in and of themselves.

Hughes, 314 Or at 21 – 22, fn. 27.

After concluding that the tax exemption statute was part of the PERS contract, the *Hughes* court sought to identify which PERS benefits the statute exempted from taxation. The language of the statute protected any right "accrued or accruing" under the PERS statutes from all state and local taxes "heretofore or hereafter imposed." *Hughes*, 314 Or at 27-28. From this language, the court held that the state had contractually obligated itself to "exempt from state and local taxation *forever*" those benefits that had accrued or continued to accrue while the statute remained in effect. *Id.* at 29 (emphasis added). However, the court held that the statutory language did not obligate the state to exempt

from taxation "benefits that *may accrue in the future based on work not yet performed*," so that benefits that accrued as compensation for work performed after the date the exemption statute was amended were not contractually exempt from taxation. *Id.* (emphasis added). In other words, the court identified a temporal limitation based on the language of the contractual promise made by the state in the exemption statute. In identifying this limitation, the court stated that "[h]ad it chosen to do so, the legislature could have dealt with future benefits, but it did not." *Id.* at 28.

In sum, the approach the court took in *Hughes* placed a particular emphasis on the context of the statute at issue to determine whether the statute was part of the PERS contract. The court then analyzed the particular text of the statute at issue to determine the scope of the benefits to which the contractual obligation applied.

In *OSPOA*, the majority opinion held that three amendments to the Oregon Constitution impaired the PERS contract because of the way they contradicted a number of existing statutes that the court held were part of the contract. In reaching its conclusions, the majority opinion did not focus on the language of the relevant statutes to determine whether they formed part of the PERS contract or whether the obligations they created applied to both benefits accrued and to be accrued in the future. Instead, the majority opinion considered the obligations imposed by the various statutes that form the PERS contract as a singular element. For example, without differentiation between statutory provisions, the majority opinion states that "[t]he statutory pension system and the relationship between the state and its employees clearly established a *contractual obligation to provide an undiminished level of benefits at a fixed cost*." *OSPOA*, 323 Or at 375 (emphasis added).

Unlike *Hughes*, the majority opinion in *OSPOA* appears to conclude that a public employee's tendering part performance through his or her work freezes the terms of the PERS contract for that employee, obligating the state to apply the terms existing when the employee began working (or any better terms offered during the period of the employee's service) to benefits accrued throughout the entirety of the employee's tenure. *OSPOA*, 323 Or at 375-376. This perspective is contrary to that displayed in *Hughes* where, once the court determined that the tax exemption statute was part of the PERS contract, it then separately examined the text of the statute to determine the scope of the benefits to which the contractual promise of exemption applied. *Hughes*, 314 Or at 27-28.

We note below when and how our answers to the questions posed would differ depending on which analytical approach Oregon's appellate courts ultimately apply.

B. Impairment or Breach

If an existing statute comprises part of the PERS contract and therefore obligates the state with regard to how it acts in relation to accrued benefits, or to both benefits accrued and to be accrued in the future, each of your questions asks whether the amendment or repeal of that law made by HB 2003 or HB 2004 would constitute an "impairment or breach" of a contractual promise.

The consequences of an "impairment of contract" differ from the consequences of a "breach of contract." The remedy for the former voids the attempt to nullify a part of the contract; the remedy for the latter gives legal effect to the enactment but requires the breaching party to pay damages.

To impair a contract violates both the Oregon and U.S. Constitutions. Article I, section 21, of the Oregon Constitution provides in part that "[n]o * * * law impairing the obligation of contracts shall ever be passed * * *." The constitutional prohibition against the impairment of contracts applies to contracts made by the state. *Eckles*, 306 Or at 390. Article I, section 10, clause 1, of the U.S. Constitution prohibits a state from passing any law impairing "the Obligation of Contracts." An impairment of contract eliminates a contractual obligation previously incurred by the state so that the state may alter its conduct without contractual liability to the other party or parties to the contract. *Hughes*, 314 Or at 31. Because a statute creating an impairment of contract is unconstitutional, it is a "nullity." *Id.* at 31. Following rules established by the Oregon Supreme Court, we determine whether the amendments made by HB 2003 and HB 2004 would violate the state's constitutional prohibition against impairment of contracts.[5] *Id.* at 12.

While an impairment of contract eliminates a basis for the state's contractual liability, a "breach of contract" violates a contractual obligation that continues to exist. The other party or parties to the contract have a right to compensation for the breach. *Hughes*, 314 at 32. *Hughes* held that the 1991 law at issue in that case both impaired and breached the PERS contract with regard to the state's obligation to exempt accrued and accruing PERS benefits from taxation. We briefly review *Hughes* to further explain the differences between impairment and breach of contracts.

The 1991 law at issue in *Hughes* affected employees' contractual rights to tax-exempt benefits in two ways. *See* Or Laws 1991, ch 823. First, it added a new subsection to the existing PERS tax-exemption statute, which formed part of the PERS contract, to make the exemption inapplicable to state personal income tax. *Hughes*, 314 Or at 10. Second, the law repealed a tax statute that had made the PERS tax-exemption statute part of the state income tax law. *Id.* By narrowing the exemption statute and changing the income tax laws, the 1991 law resulted in the taxation of PERS benefits. *Hughes* treated the two aspects of the 1991 law differently.

First, the court held that, in making the exemption inapplicable to state personal income tax, the 1991 law *impaired* the PERS contract. *Hughes*, 314 Or at 31. By eliminating, with respect to personal income tax, the state's contractual obligation to exempt PERS benefits from taxation, the law "would allow the state to subject formerly exempt PERS retirement benefits to state income taxes without contractual liability to petitioners – a result directly within the prohibition of Article I, section 21." *Id.* The amendment to the exemption statute did not itself create the taxation of PERS benefits. It did purport to *eliminate a term of the contract*, thereby depriving PERS members of a remedy if their benefits were subsequently subjected to taxation. Therefore, this portion of the 1991 law was "a nullity as it relates to PERS retirement benefits accrued or accruing for work performed before [its] effective date." *Id.*

Second, the court held that, in repealing the tax statute making the PERS exemption statute part of the state income tax law, the 1991 law *breached* the PERS contract because the repeal "result[ed] in the taxation of PERS retirement benefits." *Hughes*, 314 Or at 32. This portion of the 1991 law did not alter the statute that exempted PERS benefits from taxation and that the court found to be part of the PERS contract. Instead, it had the legal effect of subjecting PERS benefits to taxation. Because the court invalidated the attempt to alter the PERS contract to permit taxation of benefits, the attempt to tax those benefits was a breach of that contract.

FIRST QUESTION: Part A.
The "Look Back" Provisions of HB 2004

This section addresses whether Section 4, the "look back" provision in HB 2004, which addresses the use of actuarial factors in the calculation of benefit payments, adequately protects the rights of public employees that exist under the PERS contract. If HB 2004 does not change the existing use of actuarial factors, it is obvious that no breach or impairment of contract would occur. Consequently, we first compare existing law to HB 2004. Because we conclude that HB 2004 would change existing law to the detriment of some PERS members, we then analyze in turn whether the changes made by HB 2004 are constitutionally permissible (Part A of the first question presented), and whether those changes alter the plan's tax-exempt status (Part B of the first question presented).

A. ORS 238.630(3)(g), OAR 459-005-0055 and HB 2004: How The Bill Would Change Existing Law.

ORS 238.630(3)(g) states that the PERS Board "[s]hall determine the actuarial equivalency of optional forms of retirement allowances and *establish from time to time for that purpose the necessary actuarial factors*, which shall constitute a part of the

system" (emphasis added). The Board has promulgated administrative rule OAR 459-005-0055 to implement that statute.

For public employees who became members of PERS on or after January 1, 1999, the rule provides that the Board's adoption of new actuarial factors will apply on a prospective basis only. OAR 459-005-0055(4)(b) and (6)(a). Sections (4) and (6) state:

> (4) The Board shall adopt, reject, or modify and adopt as modified the consulting actuary's recommended changes to the actuarial equivalency factors used by the System within 60 days of receipt of the actuary's report on the Actuarial Equivalency Study, or as soon as practicable thereafter, at a regularly scheduled meeting of the Board.
>
> (a) Any changes to the System's actuarial equivalency factors shall be on the date established by the Board upon adoption of the changes. Upon adopting any changes, the Board shall establish the date those changes are effective.
>
> (b) All changes to the System's actuarial equivalency factors shall be prospective only for that portion of an allowance attributable to service as an active member beginning on or after the effective date of the change.
>
> * * * * *
>
> (6) For members who establish membership in PERS on or after the date designated in section (5) of this rule:
>
> (a) Benefits shall be based on the set of actuarial equivalency factors in effect for each segment of a member's active membership in PERS effective with the date of each new set of actuarial equivalency factors.
>
> (b) The calculation of benefits using different sets of actuarial equivalency factors as described in subsection (4)(b) of this rule shall be as follows:
>
> (A) For benefit calculations based on the Full Formula method (ORS 238.300(1)) and (2)(a):
>
> (i) The pension portion of the calculation which is provided by employer contributions shall use the Service Pro-Rate Method defined in section (7) of this rule; and
>
> (ii) The annuity portion of the calculation which is provided by employee contributions shall use the Segment With Interest Method as defined in section (7) of this rule.

> (B) For benefits based on the Money Match calculation (ORS 238.300(2)(b)(A)), the annuity which is provided by employee contributions shall use the Segment With Interest Method as defined in section (7) of this rule and that annuity shall be matched by a like annuity provided by employer contributions.

Under these sections of the rules, the Board will apply the actuarial factors in effect at the time particular benefit amounts, plus related interest, accrued to calculate a retiree's benefit payment. *Id.*

For PERS members who became members prior to January 1, 1999, OAR 459-005-0055(5) states:

> [T]he Board shall not change a factor that would produce a lower periodic or single benefit payment, and any change of factor(s) shall apply to the total allowance payable.

Section (5) prohibits the Board from applying new actuarial factors if their use would result in a lower periodic or single benefit payment. The practical effect of Section (5) is that the actuarial factors used to calculate retirement benefits for public employees who became members of PERS prior to 1999 are based on life expectancy figures established in 1978 and amended to some extent in the 1980s. Because these figures are lower than current life expectancies, larger monthly retirement benefit payments result from OAR 459-005-0055(5) than if the Board used updated actuarial factors.

HB 2004 would require the PERS Board to adopt new actuarial equivalency factor tables every two years for use in calculating all PERS benefit payments, with the first newly adopted table being effective January 1, 2005. HB 2004, §§ 2(1), 3. Under Section 4, the "look back" provision of HB 2004, the actuarial factors used in calculating a service retirement allowance depend on a member's retirement date.

For a member retiring on or after July 1, 2003, but before January 1, 2005, Section 4 of the bill requires the Board to calculate the service retirement allowance in two ways, and then to pay the higher of the two. As we understand the provisions of Section 4, the first amount is calculated based on the member's effective retirement date. Under subsection (1), it appears the Board is required to develop actuarial equivalency factor tables based on the mortality assumptions adopted by the Board on September 10, 2002. HB 2004, § 4(1). Then the Board is required to apply those actuarial equivalency factors to the member's entire retirement account balance as of the effective date of retirement. HB 2004, § 4(2)(a). The Board then is also required to calculate a second amount by creating an account balance as of June 30, 2003, comprised of only the

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employee contributions and earnings accrued as of that date. HB 2004, § 4(3). The Board would then use that account balance to determine the refund annuity under ORS 283.300, using the actuarial equivalency factor tables in effect on June 30, 2003. The member is entitled to receive the higher of these two amounts. HB 2004, § 4(2).[6] *Id.*

Section 4 of HB 2004 provides for the same two calculations to apply to PERS members retiring on or after January 1, 2005. For retirements beginning in 2005, the Board either would apply the actuarial factors in effect on the member's effective date of retirement to the member's entire employee contribution and earnings balance, or would use the actuarial factors in effect as of June 30, 2003, but would then calculate the refund annuity only from the employee contribution and earnings accrued as of that date.[7] HB 2004, § 4(2), (3).

While HB 2004 limits the discretion of the Board in adopting actuarial factors, it does not specifically amend the terms of ORS 238.630(3)(g). However, enactment of the bill, including the look back provision, would effectively void the salient provisions of OAR 459-005-0055 for some employees. Under HB 2004, benefit payments to some PERS members currently covered by OAR 459-005-0055(4), (5) and (6) who retire on or after July 1, 2003, would no longer be calculated based on the entirety of the member's benefits as provided in the rule. Because actuarial factors consistent with up-to-date life expectancy figures in all likelihood will produce lesser benefit amounts than the Board's currently established factors, we believe that implementation of Section 4 of HB 2004 will result in the payment of reduced retirement benefits.[8] Since the bill would change existing law as described, we must analyze whether the provisions of law changed by the bill, specifically, OAR 459-005-0055, are part of the PERS contract.

B. Is OAR 459-005-0055 Part of the PERS Contract?

Nothing in the text of ORS 238.630(3)(g) can be construed as a promise to public employees to use any particular actuarial factors or to use factors that will establish a particular result other than "actuarial equivalency" between the retirement allowances available under PERS. The state does not offer, in the statute itself, any promise about the applicable actuarial factors to be used to calculate benefits. In fact, the statute itself provides that actuarial factors may be revised from time to time by the Board. If ORS 238.630(3)(g) stood alone, we could not conclude that the PERS contract included a promise to limit the state's power freely to change the applicable actuarial factors.

But ORS 238.630(3)(g) expressly authorizes the Board to make decisions about actuarial factors. As previously discussed in this opinion, the Board adopted OAR 459-005-0055 to implement this statute. Therefore, we must analyze whether this rule is part of the PERS contract that cannot lawfully be impaired by the Legislative Assembly.

1. An administrative rule may establish terms of the PERS contract.

If administrative rules cannot ever give rise to contractual rights, it obviously follows that Section 4 of HB 2004 would not impair the PERS contract. As previously noted, the state argued unsuccessfully in *Hughes* that recognition of a statutory contract right that binds future Legislative Assemblies is inconsistent with the general rule that each session of the Legislative Assembly has plenary law-making authority. The same argument might be made with even more force where the binding effect of the unilateral offer arises not from the Assembly itself but from an administrative rule.

Nevertheless, we believe it likely that the appellate courts will determine that an administrative rule can create constitutionally protected contract rights. The legislature has authorized agencies to bind the government to many different promises. For example, an entire statutory chapter (ORS ch. 279) is devoted to the procedures by which agencies may enter into contracts involving the public fisc. A state agency's "[a]dministrative rules and regulations are to be regarded as legislative enactments having the same effect as if enacted by the legislature as part of the original statute." *Bronson v. Moonen*, 270 Or 469, 476, 528 P2d 82 (1974). The reasoning in *Hughes* and in all of the opinions in *OSPOA* does not hinge upon the fact that a statute, as opposed to a rule, helped established the contractual obligations alleged to exist in those cases. Although the court has not directly given contractual status to an administrative rule, it has given contractual force to an *agreement* entered into by PERB. In *Stovall v. State*, 324 Or 92, 110, 922 P2d 646 (1996), the Court considered the contractual rights of employees once covered by school district retirement plans but subsequently covered by PERS. The court found that the statute providing for the integration of these employees into PERS "allowed PERB, the local school board, and the local teachers' association to set the terms of the contract." We perceive no logical reason to conclude that PERB has authority to bind the state to a contract by executing an agreement but not by adopting a rule with promissory intent.[9] We turn, therefore, to an analysis of the potential binding contractual effect of OAR 459-005-0055.

2. Was the Board empowered by ORS 238.630(3)(g) to enact OAR 459-005-0055?

A state agency, such as the Board, has "only those powers that the legislature grants and cannot exercise authority that it does not have." *SAIF Corp. v. Shipley*, 326 Or 557, 561, 955 P2d 244 (1998), *citing Ore. Newspaper Pub. v. Peterson*, 244 Or 116, 123, 415 P2d 21 (1966) ("In the absence of a statute which grants a presumption of validity to administrative regulations, an administrative agency must, when its rule-making power is challenged, show that its regulation falls within a clearly defined statutory grant of authority" (citation omitted)).[10] To determine whether the legislature intended to delegate to the Board the authority to contractually bind the state to the terms of OAR

459-005-0055, we consider the legislature's intent in enacting ORS 238.630(3)(g), the statute the Board cites as being implemented by that rule.

In seeking to discern the legislature's intent in enacting ORS 238.630(3)(g) we first consider the statute's text and context.[11] As previously noted, ORS 238.630(3)(g) states that the PERS Board "[s]hall determine the actuarial equivalency of optional forms of retirement allowances and establish from time to time for that purpose the necessary actuarial factors, which shall constitute a part of the system." The text of subsection 3(g) imposes two obligations on the Board: to determine actuarial equivalencies for optional forms of retirement allowances and to establish the actuarial factors needed to make those determinations. The relevant context for interpreting ORS 238.630(3)(g) includes statutes establishing the Board's general powers and duties.

The PERS Board is the "governing authority" of PERS. ORS 238.630(1). As such, it has the "powers and privileges of a corporation," ORS 238.630(2)(a), including the power to enter into contracts. The Board also has the "power and duty" to "manage" [12] PERS, with its authority being explicitly "subject to the limitations" of ORS chapter 238. ORS 238.630(2)(b). These powers provide some indication that the legislature has given the Board authority to adopt OAR 459-005-0055. However, these statutes do not unambiguously speak to the legislature's intent that the Board adopt the rule. Nor do they expressly address whether the legislature intended to allow the Board to establish terms of the contract by an administrative rule. Therefore, we consult the legislative history of ORS 238.360(3)(g).

That history begins with PERB itself. On April 26, 1985, Thomas Deering, a Special Assistant Attorney General, provided advice to PERB regarding a then-recent change in federal tax law. Mr. Deering, a tax expert, had by then provided advice for many years to the Department of Justice and to PERS about the conditions under which contributions to public employer pension plans qualify for tax exemption. His advice was described as follows in the minutes for PERB's April 26, 1985 meeting:

> Tom Deering outside tax counsel reported on changes in federal law now affecting this pension plan.
>
> Those changes now require that a plan state in the plan document the actuarial factors that are used to determine alternate forms of benefits. The law requires that once we fix these actuarial equivalents everyone under the plan is entitled to a 'Grandfather protection' if we decide to change the factors in the future.
>
> He suggested, instead of changing Chapter 237, we could specifically authorize this board to make that determination as recommended by the

> actuary and state that the factors that the board adopts become part of the system.

PERB Minutes, April 26, 1985, p 2.

ORS 238.630(3)(g) has its origins in Mr. Deering's report to PERB. The statute began as Senate Bill 149, enacted as Oregon Laws 1985, chapter 823, section 7. Senate Bill 149 as enacted amended former ORS 237.251 (current ORS 238.630(3)) by adding paragraph (g). In a letter dated May 20, 1985, to Senator Cliff Trow, Chair of the Joint Ways and Means Public Safety Subcommittee, PERS Interim Director Kenneth A. Maul asserted to the committee, as Mr. Deering had previously asserted to PERB, that what became ORS 238.630(3)(g) was required to maintain PERS' tax-exempt qualification under the Internal Revenue Code:

> Recent federal legislation now requires that * * * the actuarial factors for alternate benefit forms under [IRC] Section 401(a)(25) be stated in our plan. A qualified plan (which PERS is), must * * * state the actuarial equivalency factors. Currently, Chapter 237 does not meet * * * [this] requirement.
>
> * * * *
>
> The required provisions must be in the "plan," *i.e.*, in ORS Chapter 237. There are good reasons, however, not to spell out actuarial factors or detailed elaborate benefit limits in the statute. If the details went into Chapter 237, a statutory amendment would be required whenever changes were necessary, which would reduce flexibility. To satisfy the IRS without cluttering up Chapter 237 with details, we have been advised that ORS 237.251(3) be amended as described in the attached suggested amendment.
>
> As I indicated to the Senate Labor Committee on April 18, 1985, it is necessary for the pension plan to receive technical corrections to maintain conformance with new federal laws.

Given the foregoing, there can be no doubt that the Legislative Assembly intended by ORS 238.630(3)(g) to authorize the Board to adopt actuarial tables as necessary to maintain PERS' tax exempt status.[13] From its earliest inception, ORS 238.630(3)(g) was linked to the necessity of conforming PERS to federal tax requirements as PERB understood those requirements. But this conclusion begs an important question: was the Board authorized *only* to do the minimum necessary to retain tax exempt qualification? Or was the Board instead authorized to weigh the risks of alternatives and then to select the course that in its judgment most likely would result in continued tax exempt

qualification? Answering this question is essential because, if OAR 459-005-0055 exceeded the Board's statutory authority, the rule is void and could not form any part of a contract. If, on the other hand, OAR 459-005-0055 was within the Board's authority to adopt, further analysis is required to determine whether the rule has become part of the PERS contract.

The text of ORS 238.630(3)(g) does not require PERB to adhere to any particular method for complying with tax qualification requirements. Indeed, the text itself, supported by Mr. Maul's comments, indicates that the Legislative Assembly intended to allow PERB to determine the appropriate method for reaching the outcome – tax qualification – that was the animating factor in adoption of ORS 238.630(3)(g). Nothing in the text itself required PERB to choose one policy option over another for achieving and maintaining tax exempt qualification for PERS. To further understand the extent of PERB's power to select among alternative strategies for securing federal tax exempt qualification, we turn to the context surrounding ORS 238.630(3)(g).

By virtue of Mr. Maul's express reliance upon them, "New federal laws" – specifically including Internal Revenue Code Section 401(a)(25) – are part of the "context" that helps give meaning to the scope of the Board's authority under ORS 238.630(3)(g). Federal requirements applicable to PERS constitute the context most salient to the Board's adoption of OAR 459-005-0055. And the most salient feature of those requirements is that they are uncertain. As discussed in the following paragraphs, tax experts disagree about the implications of those requirements for changes in actuarial tables, and, as we suggest – on page 24 in Part B of the answer to your first question – the IRS has not issued any unambiguous determination of how those requirements would be applied to amendments to PERS' actuarial tables. We conclude that the appellate courts likely would hold that OAR 459-005-0055 was an authorized exercise of judgment by the PERS board under ORS 238.630(3)(g) even though, as described below, the rule is more generous to beneficiaries than federal tax law may require.

Treasury Regulation § 401-1(b)(1)(i) requires that a defined benefit pension plan must provide benefits that are definitely determinable for the plan to be tax qualified. Since 1979, the Internal Revenue Service (IRS) has made clear that the actuarial factors used to determine benefits must be stated in a defined benefit plan in order for the benefits to be "definitely determinable." Rev Rul 79-90. Treasury Regulation §401-1(b)(1)(i) and Rev Rul 79-90 arguably are consistent with the proposition that benefits satisfy federal standards for tax qualification whenever any actuarial rule is in force. In this reading of Regulation §401-1(b)(1)(i) and Rev Rul 79-90, the actuarial assumptions applicable to calculating benefits could be changed at will as long as the arithmetic calculation always yielded a definite amount. If this reading were correct, then PERB or the Legislative Assembly could change actuarial tables at will, including making changes that apply to benefits that already had accrued at the time the mortality assumptions were

changed. This reading, however, may be foreclosed by a subsequent interpretation issued by the IRS.

In 1981, the IRS decided that the definitely determinable rule would not be satisfied unless the actuarial factors for determining benefits *could not be changed to reduce a participant's accrued benefit*. Rev Rul 81-12. According to that ruling, accrued benefits can be preserved in at least two ways. One method is for a plan to make the benefit after the change equal to *the greater of* (1) the accrued benefit prior to the change or (2) the total benefit (including post-change accruals) calculated using the new factors. For convenience, we refer to this as the "alternative benefit" rule. A second method is to calculate accrued benefits at the pre-change level using existing actuarial factors and add the benefit from accruals after the date of change, calculated using the new factors. Because benefits for any given employee may be made up of successive calculations applying different factors, we refer to this as the "segmented benefit" rule. Either approach fulfills the requirements of Rev Rul 81-12.

An example may help clarify the differences between these two approaches. Assume an individual has accrued $10,000 in benefits prior to a change in actuarial factors and accrues an additional $100 in benefits each month. Under the alternative benefit rule, one would have to make two calculations for comparison: (1) apply the old actuarial factors to the $10,000 accrued prior to the change (plus any interest on that accrued amount or other necessary adjustments)[14] and determine the amount of retirement benefits, and (2) apply the new actuarial factors to the $10,000 plus all additional benefits accrued at the time of retirement and determine the amount of retirement benefits. To maintain its tax exempt qualification, the plan would have to entitle the retiree to receive the greater of these two retirement benefits. The longer the individual works after the change, the more likely the second figure (applying the new actuarial factors to the entire amount accrued) will produce a larger retirement benefit and eventually the old actuarial factors are phased out. Under the segmented benefits rule, the old actuarial factors would be applied to the $10,000 in benefits (plus any interest on that accrued amount or other necessary adjustments) and the new actuarial factors would be applied to all benefits accrued after the change. The retirement benefit would be the combination of these figures and there would never be a complete phase-out of the old actuarial factors for members participating in the system prior to the change.

In 1984, Congress enacted the Retirement Equity Act and added to the IRC a new §401(a)(25) which states: "A defined benefit plan shall not be treated as providing definitely determinable benefits unless, whenever the amount of any benefit is to be determined on the basis of actuarial assumptions, such assumptions are specified in the plan in a way which precludes employer discretion." There is no doubt that PERB and the Legislative Assembly believed in 1985, when ORS 238.630(3)(g) was added, that IRC § 401(a)(25) applies to PERS and other government plans. The text of the federal

statute is consistent with the view that a plan may retain its tax exempt qualification even if the plan is amended from time to time to revise the actuarial tables applied to accrued benefits; under such a plan, the actuarial assumptions would be at all times specified and the employer obliged to apply them as they exist at the time the employee retired. To maintain tax exempt qualification, benefits provided under a defined benefit pension plan must be "definitely determinable." Treasury Regulation §401-1(b)(1)(i). This regulation, too, is consistent with the view that the plan could be tax exempt even if actuarial tables were routinely revised and applied to accrued benefits. But the legislative history of 26 USC §401(a)(25) cites and appears to rely on Rev Rul 81-12, thus suggesting that 26 USC §401(a)(25) codifies the limitations set out in that ruling, and further suggesting that, despite the absence of any explicit language to this effect, the new statute was intended to confirm that PERS and other governmental defined benefit plans were subject to Rev Rul 81-12.

As previously noted, ORS 238.630(3)(g) was enacted in 1985. PERB first exercised the authority granted by that statute on March 29, 1993 when it adopted OAR 459-005-0055. PERB Minutes, March 29, 1993, p. 6. The PERS Director, Fred McDonald, informed PERB that the proposed rule stated "that the Board will not change any annuity factor that would produce a lower benefit." Memorandum from Fred McDonald, March 26, 1993, to Members of the PERS Board, p 1. In a subsequent report, PERB's actuary reiterated the Director's description of the rule:

> "If the consulting actuary's recommendation to change a factor would produce a lower benefit, the Board will not change the current factor."

Report to PERB, Actuarial Equivalency Study, July 27, 1995, p. 4. The actuary noted that "improved mortality assumptions would indicate a lower monthly benefit should be paid, however, the Board's rules call for the current factors to be retained." *Id.* at 7.

In 1996, the Board amended OAR 459-005-0055 by adding OAR 459-005-0055(4) and (6) addressed to public employees who join PERS on or after January 1, 1999. OAR 459-005-0055(4) and (6) adopt the "segmented benefit" method described in IRS Revenue Ruling 81-12 for maintaining the qualification of PERS as a tax-exempt governmental plan. While the Board could have adopted the "alternative benefit" rule to protect accrued benefits from actuarial changes, ORS 238.630(3)(g) does not mandate the use of a particular method. Moreover, the method selected by the Board is one specifically identified by the IRS as meeting federal requirements. *See* Rev-Rul 81-12. In light of the powers provided to the Board and the legislature's interest in having the Board act to maintain PERS' status as a qualified plan, the PERB's decision to apply newly adopted actuarial factors on a segmented prospective basis only was lawful, even if federal tax exemption qualification standards requiring such limitations ultimately are

found to be inapplicable to PERS or otherwise are interpreted to permit retroactive application of revised actuarial assumptions.

OAR 459-005-0055(5) protects accrued benefits against reduction by the application of newly adopted actuarial factors for those public employees who joined PERS before 1999. Unlike Sections (4) and (6), Section (5) of the rule adopts a method to protect accrued benefits that is different from either of those offered in IRS Revenue Ruling 81-12. OAR 459-005-0055(5) might be characterized as a "frozen benefit" rule because the Board will not apply new actuarial factors, *even on a prospective basis*, if the newly adopted factors "would produce a lower periodic or single benefit payment." Thus, Section (5) of the rule commits the Board to acting as specified with respect to all benefits, whether accrued or to be accrued in the future. While OAR 459-005-0055(5) complies with federal requirements, it provides a more generous guarantee to public employees who joined PERS before 1999 than is needed to meet the federal standards. The Board adopted this provision restricting its future actions even though, according to advice received, all that was required to keep PERS a qualified governmental retirement plan was a rule precluding a change in actuarial factors from decreasing a member's *accrued benefit.*

But the possibility that some other choice might equally have maintained PERS' tax exempt qualification is not evidence that the Board acted beyond its lawful authority. The Board did not exceed its authority in charting a course that maintained PERS' tax-exempt status; that much of what the Board did fell squarely within the scope of what the Legislature intended PERB to do.

The conclusion that PERB lawfully promulgated and subsequently amended OAR 459-005-0055 does not end our inquiry. We presume that PERB is authorized to do things which do not become part of the PERS contract. For example, PERB has authority to enter into lease agreements, yet we doubt that the exercise of this power defines any term of the PERS contract. Therefore, we must now analyze whether OAR 459-005-0055 defines constitutionally protected contractual rights.

3. Does OAR 459-005-0055 establish terms of the PERS contract?

The Oregon appellate courts will begin to answer this question by acknowledging that a PERS contract exists. *See e.g., Hughes,* 314 Or at 18. As previously noted, the text of OAR 459-005-0055 will be relevant but not controlling. The relevant statements in Sections (4), (5) and (6) of OAR 459-005-0055 use the term "shall" in describing how the Board will apply actuarial factors and calculate benefit payments, *e.g.*, "[b]enefits shall be based on the set of actuarial equivalency factors in effect for each segment of a member's active membership in PERS effective with the date of each new set of actuarial equivalency factors." OAR 459-005-0055(6)(a).

The Oregon Supreme Court found the former statute exempting PERS retirement benefits from state taxes to be promissory in nature based in part on its use of the mandatory verb "shall." *Hughes*, 314 Or at 26. Similarly, the mandatory language in OAR 459-005-0055 indicates a commitment on the part of the PERS Board to maintain the stated practices with regard to calculating benefit payments, at least with respect to benefit amounts accrued prior to the effective date of any amendment.[15]

The record generated by the Board when the rule was adopted in 1993, and again when it was amended in 1996, unquestionably establishes that the Board intended to hold members harmless from the reductive effect of revisions to actuarial factors. As noted above, in first adopting the rule in 1993 the Board noted that it would not change any annuity factor that would produce a lower benefit. In 1996, PERB amended OAR 459-005-0055. PERB's minutes describe the Board's understanding of the amendments as follows:

> The amendments would establish a method of implementing periodic future changes to the actuarial equivalency factors for members who establish membership in PERS after January 1, 1999, the date designated by the Board in the revised rule. There is no change of practice for current members of PERS.

PERB Minutes, August 13, 1996, p.4.

An "Editor's Note" preceding the proposed amendment described how the amended rule would establish different actuarial equivalency factors "for each segment of active membership that coincides with each set of actuarial equivalencies adopted by the Board (segmented factors/service)." The note continued:

> No change of practice for current members. All current active and inactive members of PERS shall receive benefits based on the set of annuity factors adopted by the Board in October of 1995; e.g. these members who established membership in PERS prior to the date designated by the Board.

The foregoing comments were consistent with a written report submitted to the Board by a hearings officer who conducted rulemaking hearings. He wrote: "The proposed changes would impact only newly hired employees and would establish their contract rights at that time." Hearings Officer Report, Actuarial Equivalency Factors Rule, 7/31/96, p. 4.

As to those who became members prior to any given amendment, the board clearly acted with promissory intent. And the provisions of the rule relate directly to the

calculation of PERS members' benefits –clearly a core component of the PERS pension plan. As in *Hughes*, the text and context of the rule confirm that it is part of the PERS contract.

However, as described above, OAR 459-005-0055(5) does more than protect *accrued* benefit amounts. It also promises members that the board would *never* use actuarial factors that will produce lower benefit payments. In this respect, Section (5) is qualitatively different from Sections (4) and (6) of OAR 459-005-0055. Section (4) expressly describes a process whereby PERB periodically will *change* the applicable actuarial assumptions. Likewise, Section (6) establishes that the benefit calculations for public employees who become PERS members on or after January 1, 1999, will be segmented according to the actuarial assumptions applicable at the time each employee is hired. Like Section (4), Section (6) anticipates that PERB periodically will make *changes* in the actuarial assumptions applicable to employees who join PERS on or after January 1, 1999. And, under Sections (4) and (6), the effect on monthly or total benefits payable under one or another actuarial scenario is irrelevant to the scope of the authority granted to PERB by each subsection. In contrast, Section (5) expressly uses the effect on monthly or total benefits to limit PERB's discretion with respect to employees who became PERS members prior to January 1, 1999. Unlike Sections (4) and (6), Section (5) tests the validity of a given proposed actuarial assumption against its effect on benefits.

To determine whether OAR 459-005-0055(5) constitutes a term of the PERS contract, we return to the context and history of ORS 238.630(3)(g) for indications of legislative intent. The context includes ORS 238.605. That statute requires that, at least once every two years, PERB must hire an actuary to evaluate PERS and provide recommendations "as the actuary deems advisable to facilitate administering it properly." One aspect of PERS that the actuary evaluates is the mortality of its members. *Id.* Thus, the legislature intended for the Board, in making decisions about how to manage PERS, to consider changes in actuarial factors at least every two years.[16]

In OAR 459-005-0055(5), PERB promised employees who became PERS members before January 1, 1999, that PERB would never use actuarial factors that would produce lower benefit payments, regardless of objective changes to average life expectancy figures. That promise prevents PERB from applying new actuarial factors that take account of increased life expectancies. Under OAR 459-005-0055(5), the Board could respond to an actuary's recommendations by adopting new actuarial factors applicable to the protected group of PERS members only if the change would maintain or increase the level of their benefit payments.[17]

There is nothing in the history of ORS 238.630(3)(g) to indicate that in enacting it the legislature intended to authorize the Board to bind the state to a contract that did not reasonably appear to be necessary to comply with federal requirements. To accomplish

that aim, the Board did not need to freeze actuarial factors used in calculating benefits for employees who joined PERS prior to 1999. OAR 459-005-0055(4) and (6) satisfied the IRC requirements as PERB understood them. The legislature's lack of intent for ORS 238.630(3)(g) to provide for any substantive change to the statutory contract beyond what the Board reasonably believed was needed for PERS to remain a qualified governmental retirement plan is emphasized by the PERS interim director's testimony that the amendment later codified as ORS 238.630(3)(g) was "housekeeping in the strictest sense of the word." Testimony of Kenneth A. Maul, May 20, 1985, Hearing of the Joint Ways and Means Public Safety Subcommittee, SB 149, Tape 177, side A at 53.

The requirement that the PERS Board have an actuary evaluate the condition of PERS and make recommendations about its administration has existed since 1953.[18] *See* Or Laws 1953, ch 200, § 12 (now codified as ORS 238.605). Prior to the addition of paragraph (g) to the forerunner of ORS 238.630(3), it appears that the Board established all actuarial factors needed to calculate member benefits through exercise of its overall management responsibilities under ORS 238.630(2)(b), in consideration of the actuarial evaluation required under ORS 238.605. There was no intent apparent on the legislature's part for the addition of paragraph (g) to give broad contractual authority to the PERS Board beyond that reasonably needed to make the system's use of actuarial factors comply with federal requirements.

Based on a review of the text, context and history of ORS 238.630(3)(g), we conclude that the legislature did not intend, by the addition of paragraph (g) in 1985, to authorize the PERS Board to amend the statutory PERS contract by the terms of OAR 459-005-0055(5), *except* to the same extent as the protection provided by sections (4) and (6) of the rule, *i.e.*, the protection of accrued benefits against reduction by the application of new actuarial factors. We conclude that the Board's adoption of OAR 459-005-0055(5) does not constrain the legislature's authority to require the Board to act to establish new actuarial factors on a prospective basis to all members. The legislature is free to require the Board to adopt, according to a specific schedule, new actuarial factors that are consistent with current life expectancy data and to apply those factors to benefits accrued subsequent to their adoption.

We do *not* conclude that PERB lacked authority to limit *itself* by adopting OAR 459-005-0055(5). As noted above, PERB has broad authority to manage PERS, and to do so, it may select among many policy options. But we do conclude that PERB lacked authority to contractually bind the state in perpetuity to the terms contained in OAR 459-005-0055(5).

C. Does HB 2004 (Section 4) Impair or Breach Contract Rights of Public Employees Who Became PERS Members Before the Effective Date of HB 2004?

HB 2004 changes the benefit calculation that otherwise would have been performed by the Board under OAR 459-005-0055(4), (5) and (6). Under Section 4 of HB 2004, the Board would either apply newly adopted factors to the totality of the member's benefits or apply existing actuarial factors but determine payment amounts based only on the member's benefits accrued as of June 30, 2003. We assume that life expectancy has increased since the current factors were determined. Therefore, the first calculation would reduce monthly benefit payments at least for those PERS members retiring within several years of January 1, 2005. Because the second calculation would entirely exclude consideration of benefits accrued after June 30, 2003, it also would produce a lower benefit payment than that provided under OAR 459-005-0055.

As explained above, public employees who became members of PERS prior to 1999 do not have contract rights in the use of particular actuarial factors in relation to benefits not yet accrued for work not yet performed. But they do have a contract right in the promises made in OAR 459-005-0055(5) to the extent that paragraph 5 protects *accrued benefits* from being lowered by the application of newly adopted actuarial factors and provides for the calculation of benefit payments on the basis of the entirety of a member's eligible service. Section 4 of HB 2004 does not protect these rights. For public employees who became members of PERS before 1999 and who retire between July 1, 2003 and January 1, 2005, Section 4 requires the application of new actuarial factors based upon the mortality assumptions of the actuary's 2001 Experience study adopted by the Board on September 10, 2002 to determine the member's benefits or requires the application of existing actuarial figures to only a part of the member's eligible service. For reasons previously discussed, this requirement will result in a reduced level of benefit payments from those to be paid under OAR 459-005-0055. For public employees who became members of PERS before 1999 and who retire on or after January 1, 2005, Section 4 similarly requires the Board to either apply the newly adopted factors to the totality of the member's benefits or apply existing actuarial factors but determine payment amounts based only on benefits accrued as of June 30, 2003. As discussed in the preceding subsection, either of these options would produce a benefit payment reduced from that currently provided under OAR 459-005-0055, at least for those PERS members retiring within several years of January 1, 2005.

HB 2004 does not preempt OAR 459-005-0055(5)'s calculation of a member's benefit payment(s) in a way that protects already accrued benefits from application of newly adopted actuarial factors or ensures calculation of benefit payments based on all benefit amounts accrued at the time of retirement. Instead the bill, including the "look back" provisions in Section 4, effectively voids Section (5) of the rule. Because the bill

impairs the terms of the PERS contract provided by OAR 459-005-0055(5), Section 4 of the bill does not adequately protect the contract rights of public employees who became members of PERS before January 1, 1999.

For these same reasons, HB 2004 does not adequately protect the contract rights of public employees who became members of PERS after January 1, 1999, but before the effective date of the act. As described above, OAR 459-005-0055(4) and (6) establish the "segmented benefit" approach to revisions of actuarial equivalency factors. HB 2004 does not adopt such a "segmented benefit" approach but rather adopts the "alternative benefit" approach looking back to service rendered prior to the effective date of the act. Inasmuch as OAR 459-005-0055(4) and (6) expressly state that any change to the "segmented benefit" approach will only be made on a prospective basis, the terms of HB 2004 substantially change the terms of OAR 459-005-0055(4) and (6) for those who became PERS members after January 1, 1999, but before the effective date of the act.

HB 2004 does not breach the provisions of OAR 459-005-0055(4) and (6) that establish the calculation of a member's benefit payment(s). Instead the bill, including the look back provisions in Section 4, effectively voids them, thereby impairing the PERS contract of which the rule is a part. Therefore, Section 4 of the bill does not adequately protect the contract rights of public employees hired on or after January 1, 1999 but prior to the effective date of HB 2004.

FIRST QUESTION: Part B.
The Tax Qualification Issue

PERB has, by longstanding practice, employed outside counsel expert in tax matters to assess and maintain the plan's tax-exempt status. To answer your question, we sought the opinion of Mr. Donald Burns, a tax practitioner of standing in the legal community. We also reviewed confidential legal advice provided over the years to PERB.

Mr. Burns' analysis is attached as Exhibit A. He "cannot say with certainty whether the proposed change in actuarial factors will or will not income tax disqualify PERS." He suggests that the requirement that benefits be defined and determinable could be met even if actuarial factors were applied to benefits that had already accrued for work that had already been performed at the time that the factors were revised; in such a plan, benefits would be defined and determinable at any moment because actuarial assumptions would always exist at the moment benefits were calculated.

Mr. Burns acknowledges that he is not certain that his conclusion is correct. Substantive arguments can be arrayed against his suggestion. Private letter rulings are not controlling on the IRS, and the discretion that Mr. Burns accords the state with

respect to changes in the actuarial assumptions may have been foreclosed by Revenue Rulings 79-90 and 81-12 – which are controlling on the IRS. As previously indicated, PERB's minutes reflect that it has been advised that it is subject to the IRC tax exempt qualification standards.

There is unanimity, however, on the proposition that PERB should seek an IRS determination about PERS tax qualification status in light of changes made by the 2003 Legislative Assembly. A determination may be pursued even after the changes have been implemented; if a determination is pursued in compliance with IRS rules, and if the determination is adverse, the plan would be allowed to make conforming changes without penalty. Rules governing such a determination require specialized expertise. The Attorney General would authorize PERS to retain Special Assistant Attorneys General to pursue a determination from the IRS.

SECOND QUESTION
(Employee Contributions and HB 2003)

Under the current system, most active PERS members contribute six percent of their salary to the fund. ORS 238.200(1)(a). Active PERS members who earn less than $1000 a month salary contribute less. ORS 238.200(1)(b). These employee contributions are deducted by the employer automatically and credited to the member account. ORS 238.200(2). The employer may, by a written employment policy or agreement, agree to assume or pay the full amount of the employee contributions to the fund. ORS 238.205.

HB 2003 changes the current system by eliminating the employee contributions as of January 1, 2004. Section 1(4). No legal impediment to this policy exists with respect to employees who become members after January 1, 2004. As to those who are members on December 31, 2003, the effect of this change will be to diminish the amount of growth in their accumulated contributions. This change will affect the member's retirement allowance by reducing the refund annuity portion of the member's retirement benefit.

Under the present system, the service retirement allowance consists of a "refund annuity" and a "life pension." The refund annuity is determined by "the actuarial equivalent of accumulated contributions by the member and interest thereon credited at the time of retirement[.]" ORS 238.300(1). The "life pension" "shall be an amount which, when added to the sum of the annuity provided under subsection (1) of this section and the annuity, if any, provided on the same basis and payable from the Variable Annuity Account, both annuities considered on a refund basis, results in a total of * * * 1.67 percent of final average salary multiplied by the number of years of membership in the system[.]" ORS 238.300(2)(a). This is commonly known as the "full formula" method of calculating benefits.

The current statutes provide an alternative method of calculating the amount of the required "life pension" as "[t]he actuarial equivalent of the annuity provided by the accumulated contributions of the member." ORS 238.300(2)(b). This method is commonly known as the "money match" because the life pension amount is determined by "matching" the amount of the refund annuity, which consists of the balances of the member's regular and, if applicable, variable accounts at the time of retirement. Depending on the size of the member's accounts at the time of retirement, one of the two methods will provide the larger "life pension." For most members retiring now, the "money match" formula provides the greater life pension. Under HB 2003, the members' accounts would not grow by way of employee contributions and, at some point, all members would receive the greater life pension under the "full formula" method of calculating benefits.

The question asks whether the elimination of employee contributions and the eventual *de facto* elimination of the money match benefit constitute a breach or impairment of PERS members' contract rights.[19] As already noted, it is important to observe that the legislature is free to change this portion of the system for new employees without any concern for contract rights. Consequently, these changes are permissible as they apply to newly hired employees. Furthermore, assuming that for some current employees the retirement benefits calculated under the new system would be equal to or greater than the benefits calculated under the current system, there is no contract issue as to these individuals.[20]

The potential problem arises as to current employees whose retirement benefits would be greater under the money match formula assuming the employee contribution provision did not change. Under HB 2003, these employees will receive a smaller retirement benefit than they would without the enactment of HB 2003. As discussed above, in order to answer the question whether the enactment of HB 2003 would violate a contractual obligation of the state, the first step is to determine whether the current employee contribution in ORS 238.200, and the current "money match" formula for computing retirement benefits, are components of the PERS contract. If so, the next step is to determine the scope of that contractual promise.

As the Supreme Court stated in *Hughes*, the context in which the statute is enacted is of primary importance in deciding whether the legislature intended to create a statutory promise. *Hughes*, 314 Or at 25. Both the employee contribution component of the PERS system and the "money match" method of calculating benefits were enacted as part of the Public Employees' Retirement Act of 1953. Except for a two year hiatus, both components have continuously been at the core of the PERS System.

As originally enacted, *former* ORS 237.071 provided:

(1) The objective of this Act with reference to service after July 1, 1946, shall be to provide each employee who is a member of the system and who is ineligible for participation in the Old Age and Survivors Insurance program * * * a total service retirement allowance of approximately one-half his average salary during his last five years of service for police officers and firemen with 25 or more years of membership in the system and for other employees with 30 or more years of membership in the system. For any employee ineligible for Old Age and Survivors Insurance coverage entering the system after the age of 35 years, the objective shall be to provide an allowance for service after July 1, 1946, proportionately reduced on the basis of his age at the time he first becomes a member of the system. For the purposes of this subsection no employee's compensation shall be deemed to exceed the first $3,000 earned by him during the fiscal year.

(2) The objective of this Act with reference to service after July 1, 1951, shall be to provide each employee who is a member of the system and who is eligible to participate in the Old Age and Survivors Insurance program * * * a total service retirement allowance of approximately one-quarter of his average salary earned while a member of the system for police officers and firemen with 25 or more years of membership in the system and for other employees with 30 or more years of membership in the system. For any such employee entering the system after the age of 35 years, the objective shall be to provide an allowance for service after July 1, 1951, proportionately reduced on the basis of his age at the time he first becomes a member of the system. For the purposes of this subsection no employee's compensation shall be deemed to exceed the first $3,600 earned by him during the fiscal year. Contributions shall be withheld from one-half of such earnings as shown on the payroll of the employer.

(3) Those employees who are qualified to contribute under the provisions of subsection (2) of this section and who had established an account with the system prior to July 1, 1951, shall also receive benefits from their contributions and the contributions of their employer made before July 1, 1951, as provided in subsection (1) of this section.

(4) Upon the basis of this objective and of actuarial tables approved by the board the actuary shall ascertain for each member of the system the percentage of his compensation earned after July 1, 1946, and before his compulsory service retirement age which with interest is necessary to provide approximately one-half of the benefits this Act intends for him to

> receive on account of service during that period. From each payroll during the period, his employer shall deduct that percentage of half the amount credited to him on the payroll and shall transmit the deduction to the board, which shall cause it to be credited to his account in the fund. An employee whose rate of contribution to the fund is fixed at more than five percent of his salary may elect to reduce his contribution rate to five percent by notifying the board to that effect, in which event his benefits shall be reduced accordingly; provided, that a member who has elected to reduce his contribution to five percent may increase his contribution to the fixed rate, subject to the approval of the board and in compliance with rules prescribed by it, by notifying the board in writing of his desire. No employee may elect to increase his rate from five percent to the fixed rate, nor reduce from the fixed rate to five percent, more than once in any fiscal year. * * *

Or Laws 1953, ch 200, section 13.

The 1953 Act also provided for the computation of the "money match" formula as follows:

> Upon retiring from service on account of super-annuation at compulsory retirement age a person who is a member of the system shall receive a service retirement allowance which shall consist of (1) a refund annuity which shall be the actuarial equivalent of his accumulated contributions and interest thereon credited to him at the time he retires, which annuity shall provide an allowance payable during his life * * *; and (2) a life pension (non-refund) provided by the contributions of his employers of the actuarial equivalent of the cash refund annuity provided by his accumulated contributions; and (3) an additional life pension (non-refund) for prior service, including military service, credited to him at the time he first becomes a member of the system, as elsewhere provided in this Act, which pension shall be provided by the prior service contributions of his employer or, in case he is an employee of a school district, by a uniform rate of contribution by all school districts.

Or Laws 1953, ch 200, section 18.

In 1955, the legislature amended the Act to change the anticipated retirement benefit (including Old Age and Survivors Insurance primary benefit) to 50 to 60 percent of the employee's average salary and modified the employee contribution rate. Or Laws 1955, ch 131, section 5(2). As amended, the legislature provided "A member whose salary exceeds $4,800 per year may elect to contribute on all salary in excess of $4,800 at the same percentage rate as are his other retirement contributions computed. Such

contributions will purchase at retirement, additional benefits which will be matched by the employer." The same "money match" formula for calculating retirement benefits remained in effect.

The legislature modified the employee contributions in 1967 to a straight percentage of salary, based on the amount of monthly salary. Or Laws 1967, ch 622, section 4. An employee making less than $500 a month contributed four percent of his salary, an employee making between $500 and $1000 contributed five percent, an employee making between $1000 and $1500 contributed six percent, and an employee making more than $1500 a month contributed seven percent. The legislature modified the life pension to introduce a version of what became known as part of the "pension plus annuity" method of computing benefits. A retiree would continue to receive the refund annuity from the employee's accumulated contributions and interest, but the life pension (nonrefund) provided by the contributions of his employers changed to "the actuarial equivalent of .67 percent of his final average salary multiplied by the number of years of his membership in the system, not exceeding 30, before he reaches the age of compulsory retirement." Or Laws 1967, ch 622, section 13(2). The legislature also eliminated for a brief time the money match as an alternative means to compute the life pension. *Id.*

The 1969 legislature restored the money match as one of the available alternative methods to compute the life pension (nonrefund). 1969 Or Laws, ch 640, section 7(2)(b). In the 1969 legislative changes, the legislature required that the life pension (nonrefund) had to be the greater of that calculated under the "pension plus" method and the "money match" method in order to maximize retirement benefits. The legislature expressly required that a life refund pension "shall be at least the actuarial equivalent of the annuity provided by the accumulated contributions of the person." *Id.* The legislature increased the amount included in the "pension plus" method to .84 percent and eliminated the 30-year cap in 1971[21] and increased that amount to one percent in 1973.[22]

In 1981, the legislature added the "full formula" method to its current system. Under this new alternative, a base pension is calculated as 1.67 percent of final average salary multiplied by the number of years in the system (for police officer, firefighter and legislative service, two percent is used). Or Laws 1981, ch 761, section 1, 4; ORS 238.300(2). But the "money match" alternative continued to be available after the 1981 amendments. And, for members who made contributions before August 21, 1981, the "pension plus" method remains available if it provides greater benefits. *See Sledge v. Oregon Public Employees Retirement Board*, 112 Or App 335, 339-341, 829 P2d 1037 (1992) ("[t]he full formula plan simply provides a floor, below which losses from participation in the variable annuity program before 1981 cannot fall").

Thus, since the enactment of the PERS system in 1953, the legislature has always provided for a retirement benefit that consisted of both employee contributions and

employer contributions. The legislature has modified the amount of contributions and the formula for calculating the retirement benefit. But since the "full formula" benefit calculation was enacted in 1981, this method has served to provide a minimum level of benefits. At least since the full formula benefit calculation was enacted in 1981, that formula has provided a floor below which retirement benefits will not fall. Concomitantly, the legislature has also maintained the alternative retirement benefit calculation method of the money match formula. The money match formula was part of the original PERS laws dating back to 1953 and, when it was reenacted in 1969, it was reenacted for the express purpose of making the "life pension" component of an employee's retirement benefit be at least the actuarial equivalent of the employee's refund annuity component.

Thus, the employee contribution component has always been a central part of the PERS retirement benefit system, and, at least since 1981, the "full formula" and the "money match" methods for calculating retirement benefits have coexisted as part and parcel of the PERS law for the express purpose of defining the retirement benefits of state employees. Furthermore, the PERS statutes have also had the additional and expressly stated purpose of establishing the retirement benefit amount at the higher amount resulting from the alternatively available calculation methods.

The level of retirement benefits is a core component of a retirement benefit program. Consequently, we conclude that the employee contribution provisions and the full formula and money match methods for computing retirement benefits based in substantial part on employee contributions to their retirement accounts are integral parts of the PERS statutes. Thus, the context of these provisions clearly supports the conclusion that these statutory provisions are part of the PERS contract.

In *Hughes,* the court found the exact text helpful but not essential. Just as the court did in *Hughes*, we find that the text of the relevant statute buttresses our conclusion that the right to continue to make contributions is part of the PERS contract.

First, the statutes address employee contributions in mandatory terms. For example, ORS 238.200 (1)(a) provides: "An active member of the system *shall* contribute to the fund and there *shall* be withheld from salary of the member six percent of that salary." (Emphasis added.)

Second, the retirement benefits derived in part from the employee contributions are also set out in mandatory terms. ORS 238.300 provides in pertinent part:

> Upon retiring from service at normal retirement age or thereafter, a member of the system *shall* receive a service retirement allowance which *shall* consist of the following annuity and pensions:

> (1) A refund annuity which *shall* be the actuarial equivalent of accumulated contributions by the member and interest thereon credited at the time of retirement * * *.
>
> (2)(a) A life pension (nonrefund) for current service provided by the contributions of employers, which pension, subject to paragraph (b) of this subsection, *shall* be an amount [set according to the full formula method] * * *;
>
> * * * * *
>
> (b) A pension under this subsection *shall* be at least:
>
> (A) The actuarial equivalent of the annuity provided by the accumulated contributions of the member.
>
> * * * * *.

(Emphasis added).

All of these statutes are mandatory. All of these statutes on their face unambiguously evince an underlying promissory, contractual legislative intent. *See Hughes*, 314 Or at 26. Consequently, we conclude that these statutory provisions establishing employee contributions and the full formula and money match calculation methods for establishing employee retirement benefits are terms of the PERS contract at least as to retirement benefits that have accrued or are accruing for work performed while these statutes have remained in effect.

The next question that must be addressed is whether the legislature intended the contractual promises contained in the statutes establishing employee contributions and the full formula and money match methods for calculation of retirement benefits to apply to retirement benefits that may accrue in the future based on work not yet performed. In short, we must ascertain the scope of the contract. At the outset, it must be noted that the statutory provisions at issue do not contain any expression of duration – either by way of limitation or by way of setting out the intent to have them apply forever. It would appear that this means the legislature did not contract away its ability to change these parts of the PERS retirement benefits system for benefits that may accrue in the future based on work not yet performed. *See Hughes*, 314 Or at 29. Consequently, were we to base our opinion on *Hughes* and under earlier contract cases decided by the Oregon Supreme Court, we would conclude that the legislature is free to eliminate employee contributions and change retirement benefit calculation methods for benefits that may accrue in the

future and on work not yet performed (as long as such changes protected the benefits accrued to the date of such changes).

However, *OSPOA* suggests that the Supreme Court might, if it adhered to the majority opinion in that case, conclude that employee contribution rights must be protected even as to benefits accruing for work not yet performed. In *OSPOA* the court concluded that the statutory PERS contract includes promises to the members "with respect to the cost of their participation in the PERS retirement plan and the benefits that they will receive on retirement." 323 Or at 375. As a result, the court found that a constitutional change that prohibited employers from paying the employees' contributions (and thereby increased the costs of those contributions for the employees) impaired the state's contractual promise because "the cost of participation to the employee increases while the benefits that the employee ultimately will receive on retirement decrease." *Id.*

Here, HB 2003 sets up a transition account for each PERS member and causes what formerly were employee contributions paid into the PERS fund and credited to the member's retirement account to be paid instead into the member's newly created transition account. While the transition account mechanism means that the costs experienced by PERS members will stay the same in the short term, it will have an adverse effect on the retirement benefits that PERS members will receive at retirement. And for those PERS members whose employee contributions currently are picked up by their employer, the transition account mechanism only provides for those payments to be continued until December 31, 2005. As we understand it, the transition account mechanism does not decrease costs for any PERS members, and beyond question it will reduce retirement benefits to PERS members because the retirement accounts of individual PERS members will not grow by any employee contributions in the future. Thus, all PERS members who would otherwise receive a greater PERS retirement benefit based upon the money match calculation, which is in turn based in substantial part on employee contributions credited into their individual retirement accounts, will receive decreased benefits on retirement.

In light of the *OSPOA* court's conclusion that "[t]he statutory pension system and the relationship between the state and its employees clearly established a contractual obligation to provide an undiminished level of benefits at a fixed cost" to the employee, 323 Or at 375, an appellate court that adheres to the majority opinion in *OSPOA* is likely to find that the change in employee contributions in HB 2003 unconstitutionally impairs the contract rights of many current members. Consequently, if future court decisions follow *OSPOA*, the current PERS contract will be determined to contain a promise that members will continue to contribute to their retirement accounts (or have their employers make the contributions on their behalf). The court would also hold that those accounts will continue to grow and be included in the calculation of the retirement benefit under

both the full formula and the money match formulas under *OSPOA*, and that the legislature is not free to eliminate either the members' contributions or the money match formula without impairing these contractual obligations.

THIRD QUESTION
(The "Assumed Interest Rate" and HB 2003)

Under ORS 238.255 (formerly ORS 237.277),[23] the board must annually credit earnings on Tier One[24] PERS members' individual accounts in an amount that equals or exceeds the "assumed interest rate."[25] The board periodically determines the assumed interest rate, both for purposes of ORS 238.255 and to value employer liabilities and the assets of the system as required by ORS 238.670. *See* 38 Op Atty Gen 880, 887 (1977). The assumed interest rate is the board's "educated guess as to the prospective interest earnings of the fund over the indefinite future." *Id.*[26]

HB 2003 prohibits crediting earnings to a Tier One regular account if there is a "deficit in the reserve account" or the draw on that account "would result in a deficit in the reserve account." HB 2003, Section 5. This change applies to the crediting of earnings to Tier One members' accounts beginning in calendar year 2003. *Id.* at Section (6). HB 2003 also establishes what it terms a "Minimum Account Balance." *Id.* at Section 8. Under this section of HB 2003, a Tier One member who retires after April 1, 2004 would be entitled to have his or her regular account computed as if it had been credited "at the assumed interest rate in every year that the account was in existence." *Id.*

To answer whether these changes to the guaranteed interest rate unconstitutionally impair Tier One employee's contract rights, we first consider whether the requirement that PERB credit accounts with at least the assumed interest rate is part of the PERS contract. We next analyze the specific aspects of any promise. Finally, we must consider the duration of any promise (*i.e.*, does it apply to contributions and earnings from work performed to date or does it also apply to future work). As with the preceding discussion on employee contributions to the PERS plan, the outcome depends in part on whether the courts follow the majority's approach in *OSPOA* or adhere to the approach expressed in *Hughes*.

Regardless of the analytical approach used by an appellate court on this question, we conclude that an appellate court would determine that HB 2003 impermissibly impairs Tier One contract rights as to the guaranteed interest rate on contributions and earnings thereon related to work performed before the date of any change. For the reasons that follow, we also conclude that an appellate court would determine that HB 2003 impermissibly impairs contract rights as to the guaranteed interest rate on contributions and earnings arising from future work by Tier One employees, if future court decisions follow *OSPOA*.

A. Crediting Assumed Interest Rate Earnings to Tier One Members' Accounts as a Contractual Obligation

For at least two reasons, we believe that the appellate courts will conclude that ORS 238.255 is part of the Tier One PERS members' contract. First, in *OSPOA*, the court *unanimously* held that section 11 of Ballot Measure 8 violated the Contracts Clause of the federal constitution and was void. *OSPOA*, 323 Or at 378. Section 11 prohibited the state or any of its political subdivisions from guaranteeing any rate of return on the funds in a public employee retirement system. *Id.* at 382. Although the members of the court disagreed as to their reasons, in this aspect of the *OSPOA* decision all members of the court agreed that section 11 impaired PERS members' ORS 238.255 contract rights.[27] *See OSPOA*, 323 Or at 377 (majority opinion), at 392-393 (Fadeley, J., concurring), and at 411-412 (Gillette, J., Carson, C. J., and Graber, J., specially concurring and dissenting).

Second, the terms of ORS 238.255 state mandatory obligations. In *Hughes*, the court noted that the text of a specific statute could buttress a conclusion that the statute is part of the PERS contract. Here, ORS 238.255(1) states that the regular account of each PERS member "*shall* be examined *each* year." (Emphasis added). If the actual earnings are less than the assumed interest rate earnings, the difference "*shall* be credited." (Emphasis added). *Id.* On its face, the statute unambiguously evinces an underlying promissory, contractual legislative intent. *See Hughes*, 314 Or at 26. Consequently, we conclude that the guaranteed interest rate in ORS 238.255 is part of Tier One members' contract rights.

B. Specific Promise Made in ORS 238.255

Next, we must consider the precise scope of the ORS 238.255 promise. Although ORS chapter 238 does not set a specific guaranteed rate of return, the effect of the enactment of ORS 238.255 "was to guarantee a minimum rate of return on the individual account of each PERS member." *OSPOA*, 323 Or at 377. In other words, if the earnings on an individual's regular account in a given year are less than the assumed interest rate then in effect, the board must credit the difference to the account each year.[28] As noted above, the express language of ORS 238.255's mandatory obligations (*i.e.*, "shall be credited") supports this interpretation. *See Hughes*, 314 Or at 29.

In evaluating the scope of the state's "assumed interest rate" promise, it is helpful to identify the categories of PERS rights that might exist under potentially differing durations of that promise:

1. Rights to assumed interest rate income that previously has been credited to Tier One members' individual accounts;

2. Rights to future assumed interest rate income on Tier One members' current regular account balances; and

3. Rights to assumed interest rate income on Tier One members' future contributions to their regular accounts and the earnings on such contributions.

Cf Hughes, 314 Or at 28; *see OSPOA*, 323 Or at 407 (Gillette, J., specially concurring and dissenting).

As to the first two of these categories, Tier One members already have performed the requisite labor from which these rights flow. Under the majority and both concurring opinions in *OSPOA*, any change in the ORS 238.255 assumed interest rate promise that adversely affects the first two categories would be a retrospective change. Such a retrospective change would impermissibly impair the Tier One members' contract rights. *OSPOA*, 323 Or at 377-378 (majority opinion: the state's material promise to the return rate procedure cannot be cancelled after employees performed their services), at 402 (Fadeley, J., concurring: removal of assumed interest rate guarantee eradicates accrued statutory contract rights and unconstitutionally impairs obligation of contract), and at 412 (Gillette, J., Carson C. J., and Graber, J., specially concurring and dissenting: guaranteed rate of return section applies retrospectively and is an impermissible impairment of contract). In light of the legislature's promises that the Tier One accounts "shall" be examined and credited with at least the assumed interest earnings each year, we believe in this instance that *Hughes* dictates the same result as *OSPOA* on PERS benefits "accrued or accruing for work performed so long as" current ORS 238.255 remains in effect. *See Hughes*, 314 Or at 29.

The next question that must be addressed is whether the legislature intended to apply the assumed interest rate to contributions that may accrue in the future based on work not yet performed. ORS 238.255 does not contain any expression of duration – either by way of limitation or by way of setting out the intent that it apply forever. Although an examination and any necessary credit of assumed interest must occur "each year", this language by itself or in context does not express a clear legislative intent to promise that this arrangement will never be altered as to contributions or earnings arising from future Tier One employees' work.[29] As the *Hughes* court noted, the "legislature has evidenced the fact that it knows how to refer to the future" in the PERS statutes. *Hughes*, 314 Or at 28 (referring to *former* ORS 237.201 that addressed taxes "heretofore or hereafter imposed"). Finally, there simply is no express indication in ORS 238.255 that the guaranteed interest rate promise was intended to be perpetual. To conclude that the legislature intended to include benefits that may accrue in the future as compensation for work not yet performed would be to "insert what has been omitted" in the statute, in violation of ORS 174.010.[30] *See Hughes*, 314 Or at 28. Thus, under *Hughes*, it would

appear that the legislature did not contract away its ability to change the PERS retirement benefits system in this area for benefits that may accrue in the future based on work not yet performed. *Hughes,* 314 Or at 29.

As noted above, however, the *OSPOA* court concluded that neither the people nor the legislature could make any *prospective* changes in the ORS 238.255 guaranteed interest rate promise as to public employees already on the job at the time of such a change. In reaching its conclusion on this issue, the majority opinion found Section 11 of Ballot Measure 8 (the prohibition against a contract that guarantees an interest rate) to be void because it eliminated the rate of return guarantee "with respect to employee contributions to PERS made by current employees for work performed both *before* and after the effective date of Measure 8." *OSPOA,* 323 Or at 378 (emphasis in original). Thus, as to Tier One members' regular account balances arising from work performed both before and after any statutory change, under *OSPOA* the appellate courts are likely to conclude that Section 5 of HB 2003 unconstitutionally impairs Tier One members' contract rights.

Although another section of HB 2003, Section 8, appears to attempt to ameliorate this problem in part through the "Minimum Account Balance", we do not believe that this provision cures or avoids the constitutional infirmities of Section 5. Under Section 8 of HB 2003, the regular account balance of a Tier One employee will not be less than the amount that would have existed if the account was credited with the assumed interest *every year* of the account's existence. Since regular account earnings credits in years before 2003 often exceeded the assumed interest rate, the effect of the "Minimum Account Balance" provision would be to use Tier One employees' previously accrued and credited earnings that exceeded the assumed interest rate to offset subsequent years that yield less than the assumed rate.

In sum, we conclude that prospective changes in the guaranteed rate would be permissible as to any contributions arising from Tier One members' work performed *after* a statutory change, if the appellate courts follow the *Hughes* approach. If the courts were to adhere to the majority opinion in *OSPOA,* however, any adverse change in the guaranteed rate for Tier One accounts, whether *retrospective or prospective,* would likely be found to be an unconstitutional impairment of Tier One members' contract rights.

FOURTH QUESTION
(Marion County Case)

In a lawsuit brought against the Board in 1999 by several public employers, the trial court has ruled that certain PERB actions that substantially increase the amount of a member's retirement allowance under money match are unlawful. *City of Eugene v. State of Oregon,* Marion Co. Cir. Ct. Case No. 00C16173. Under HB 2003, if the trial

court is affirmed, the cost of the unlawful benefits is to be paid from future Fund earnings. In turn, this will reduce amounts that would otherwise have been available for distribution to the accounts of members who have not yet retired and who will not receive any of the overpayments. Your question instructs us to assume that the disputed actions were unlawful[31] and asks whether recovering the costs of overpaying some members from, as a practical matter, earnings on the accounts of other members would breach or impair the latter's contract rights within the meaning of the state or federal constitutional contract clauses.

Under the assumption you prescribe, the Board's errors[32] can be summarized as follows:

1. The Board has been using mortality tables first adopted in 1978 to calculate annuities and life pensions. Those tables do not reflect increases in average life expectancy of recent retirees. HB 2003 and your question assume that the Board should have updated its mortality tables on a regular basis.

2. The bulk of members' contributions and earnings are credited to "regular accounts," which are managed pursuant to the investment strategy prescribed by ORS chapter 238. Since 1968, members have had the option of placing a portion of their contributions in "variable annuity accounts," which are invested primarily in equities. *See* ORS 238.260(1), (6). Until 2001, employer contributions could only be invested pursuant to the regular account strategy. Or Laws 2001, ch 945, § 17. For purposes of money match, the Board has required life pensions to match the full balance in both accounts, with the result that employer accounts currently are substantially underfunded relative to members who had variable accounts during the 1990s when those accounts outperformed the rest of the PERS portfolio. HB 2003 and your question assume that the Board should require that a life pension match the entire amount in a member's regular account but no more of the member's variable account than the amount that would be in it if it had been invested like a regular account.

3. Fund investments generated extraordinarily high earnings for 1999. The Board decided to distribute a substantial portion of those earnings in excess of the assumed interest rate provided for by ORS 238.255 to members' regular accounts, which has resulted, and will continue to result, in larger annuities and life pensions for members retiring under the money match formula. HB 2003 and your question assume that the Board should have distributed to members' regular accounts the assumed interest rate (8 % at the time) and allocated all or virtually all of the rest of the 1999 earnings

generated by regular accounts to reserve accounts in anticipation of economic downturns.

As a result of those actions, and assuming they were unlawful, the PERS retirement allowances for members retiring in recent years under the money match formula are in varying degrees excessive and unlawful. As to overpayments resulting from the 1999 distribution, HB 2003, Section 10 reduces the magnitude of the overpayments to members who retire between April 1, 2000, and April 1, 2004, on a going-forward basis by withholding cost of living adjustments until the correct benefit plus cost of living adjustments catches up with the overpayment.[33] As to overpayments resulting from the 1999 distribution that are not corrected by Section 10, and overpayments that result from outdated mortality tables and from matching the full amount of a member's variable account, HB 2003, Section 14b provides:

> (1) If the Public Employees Retirement Board is required to correct one or more of the erroneous benefit calculation methods identified in City of Eugene et al. v. State of Oregon, cases Nos. 99C-12794, 00C-16173, 99C-12838 and 99C-20235, 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:
>
> (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 a time as the member's benefit is equal to the correctly calculated benefit.
>
> (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 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.

A. Would HB 2003 Contravene Any Terms of Existing Law?

HB 2003 implicates elements of the existing plan in two related ways. We discuss them separately.

1. Recoupment of Overpayments From Administrative Expenses.

The first issue is whether deducting the costs identified in HB 2003 from future Fund earnings as an "administrative expense" is permitted under the terms of the PERS

contract as it currently exists. Under current law, Fund earnings are used to pay "administrative expenses," ORS 238.610 and 238.260(6), and the fees charged by variable account investment advisors, ORS 238.260(7)(b). Net Fund earnings are to be allocated by the Board to member accounts, ORS 238.250 and 238.260, employer accounts, OAR 459-007-0520, and/or the reserve accounts established by ORS 238.670. Although "administrative expenses" are not defined in ORS chapter 238, they explicitly exclude the cost of "retirement allowances," ORS 238.610(4).

ORS 238.715 currently provides for recovery of overpayments made to PERS retirees. HB 2003 is not concerned merely with the cost of overpayments that have already been made, however. HB 2003 mandates that PERB continue to pay retirement allowances in the future to a specified class of retirees in amounts not authorized under the current plan (until the correct benefits catch up) and prevents the Board from exercising existing remedies for the recovery of past overpayments. This, in effect and in law, renders the otherwise excessive and otherwise illegal benefits thereafter correct and lawful. Under these circumstances, the cost to PERS of *continuing* to make "overpayments" to retirees on money match would simply be the cost of the new "retirement allowance" which could not be charged as an administrative expense under current law. ORS 238.610(4). The same reasoning would apply to the costs of any past overpayments that HB 2003 prohibits the Board from recovering.

On the other hand, to the extent the disputed Board actions are ultimately determined on appeal to have been unlawful, the resulting overpayments to recent money match retirees would not be part of the true "retirement allowance" provided for by chapter 238. If unlawful, the 1999 distribution and the matching of variable accounts would have resulted in the transfer of an excessive amount from employer accounts to the Benefits-in-Force reserve, ORS 238.670(2), upon the member's retirement in order to fund the overpayments. Mortality tables that underestimate retirees' life expectancies mean that, on average, a member's annuity and matching life pension will be insufficient to sustain the monthly payments over time and employers will be liable for the difference. *See* ORS 238.225.

For those reasons, excessive benefits *that have already been paid to recent retirees and cannot be recovered from retirees pursuant to ORS 238.715* would result in excessive employer costs attributable to the Board's maladministration of PERS. We note, however, that ORS 238.660(3) expressly provides that public employers who contribute to the PERF have no proprietary interest in either the fund or in their contributions to the fund. In fact, all public employers participating in PERS expressly "disclaim any right to reclaim those contributions and waive any right of reclamation they may have in the fund." ORS 238.660(3). Nevertheless, to determine whether such "excessive employer costs" may be paid with Fund assets under current law, we first

refer to additional federal requirements with which PERS must comply to maintain its status as a tax-preferred governmental plan.

To maintain its status as a tax-exempt governmental benefit plan, PERS must comply with the non-diversion regulations promulgated by the IRS:

> Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the *exclusive benefit of such employees or their beneficiaries.*

26 CFR §1.401-2(a)(1). (Emphasis added). The requirements of the IRS regulation are reflected in ORS 238.660(1) and (2), which declare PERF to be a trust fund and prohibit the diversion of its assets.[34] However, nothing in the state statute limits its reach to the scope of the IRS regulation. In other words, ORS 238.660 declares PERF to be a trust fund, not just for purposes of satisfying IRS requirements, but for all purposes.

While neither 26 CFR §1.401-2(a)(1) nor ORS 238.660 provides guidance for determining whether a particular use of Fund assts would meet the "exclusive benefit of PERS members or their beneficiaries" requirement, the bill would effectively reduce the earnings distributed to some members' accounts to pay for excess benefits for others as a result of decisions made by the trustee of the PERF, namely PERB. This resolution absolves other parties (*e.g.*, public employers or taxpayers of the state of Oregon) from any liability existing under current law to pay for the errors made by PERB, and instead places the burden on at least some non-retired members of PERS who in no way benefited from the overpayments at issue. From the plain language of the phrase "exclusive benefit" it appears likely that this use of future PERF earnings[35] contemplated by HB 2003 would constitute an unlawful diversion of trust funds contrary to the IRS regulation and ORS 238.660.

We believe it is also likely that the appellate courts would turn to what the law of trusts says about the recovery of excessive benefit payments to determine the validity of these provisions of HB 2003.[36] As noted, ORS 238.660 expressly establishes PERF as a trust. Consequently, general principles of trust law will be useful to the courts at least by analogy. The appellate courts will likely conclude that maintenance of PERF according to general principles of trust law is an element of the PERS contract. Thus, we expect that general principles of trust law will be applied by the appellate courts to the bill.

The RESTATEMENT (SECOND) OF TRUSTS (1959) includes two statements about the overpayment of benefits that are important to our analysis. First, as a general comment, it states:

> If the trustee has made a payment out of trust property to one of several beneficiaries to which the beneficiary was not entitled, such beneficiary is personally liable for the amount of such overpayment, and his beneficial interest is subject to a charge for the repayment thereof, unless he has so changed his position that it is inequitable to compel him to make payment.

RESTATEMENT (SECOND) OF TRUSTS, § 254. This principle of law places the burden of making a trust whole from excessive benefit payments on those who received such payments. Second, a comment to the general statement makes clear that the assets of the trust are not liable for recovery of overpayments:

> *e. Rights of trustee and co-beneficiaries.* If the trustee makes an overpayment out of the trust estate to one of several beneficiaries, the trustee is entitled to maintain a suit against the beneficiary who is overpaid and is entitled to a charge upon the beneficiary's interest for the amount of the overpayment, and he is under a duty to the other beneficiaries to maintain such a suit or to enforce such a charge, unless he has himself made good to the other beneficiaries or has paid into the trust the amount of the overpayment, for which he is himself personally liable. See § 226. The fact that the trustee was himself at fault in making the overpayment does not preclude him from maintaining such suit or enforcing such charge. By so doing he benefits the other beneficiaries and since he is thereby relieved of personal liability he benefits himself also. Even if he himself made good the amount of the overpayment, he is not ordinarily precluded from maintaining such suit or enforcing such charge.

The current statutes governing PERS are consistent with the quoted provisions of the Restatement insofar as they authorize the PERS Board to recover excess payments from those who received them. *See* ORS 238.715.

Based on the foregoing analysis, we conclude that the use of future earnings of the PERF to pay for the excess benefits received by certain PERS retirees and beneficiaries, as contemplated by HB 2003, would more likely than not constitute a diversion of trust funds prohibited by ORS 238.660.

2. Shifting Recoupment of Overpayments from Retired Members Who Received Them to Members Who Have Not Yet Retired.

The second issue is whether the current pension plan permits shifting the costs of "excessive" and "unlawful" benefits from the recipients to members who will retire in the future. As discussed above, under HB 2003 certain money match retirees are to retain overpayments already received and either (a) continue to receive overpayments in the future, albeit frozen in amount, until the correct payment would catch up with the overpayment, and thereafter receive the correct payment; or (b) continue to receive the overpayments augmented by regular cost of living adjustments as if the original computation of the retirement allowance were correct except as provided in Section 10. In other words, none of the overpayments received or to be received by money match retirees are to be recovered and some overpayments are to continue in the future. In the latter respect, the "remedies" provision of HB 2003 is concerned with more than just the recovery of overpayments. It would have the effect of altering the plan retroactively to increase the retirement allowances for affected money match retirees beyond that prescribed by current law and to shift moneys among member accounts to accommodate the increase, *i.e.*, distribute future earnings to the Benefits-in-Force accounts for retirees receiving overpayments.

As to past overpayments, the current pension plan includes a mechanism for their recovery, including deducting them over time from a member's future monthly payments, and permits the Board's exercise of other general remedies provided by law with two exceptions. ORS 238.715. The Board may not reduce a monthly payment by more than ten percent to recover overpayments unless the member consents and may not recover an overpayment more than six years after its receipt. ORS 238.715(3), (7).[37] The Board may also write off overpayments that total $50 or less. ORS 238.715(6). But for larger overpayments, the Board is obligated to make vigorous efforts to recover all debts lawfully owed to it. *See*, ORS 293.240 (all state agencies required to make all reasonable efforts to collect money owed). In addition, as fiduciary to a trust fund, ORS 238.660(1), the Board must treat beneficiaries fairly and impartially. RESTATEMENT (SECOND) OF TRUSTS, § 183. For those reasons, under current law the Board could not forego its remedies under ORS 238.715 if the result would be to overpay one group of members at the expense of another.

As to future overpayments authorized by HB 2003, no provision of current law permits the Board to provide a retiree with monthly payments greater than those authorized by ORS chapter 238. For that reason, in addition to recovering past overpayments, the current plan would require the Board to reduce promptly the monthly retirement allowance of any member whose benefit as previously calculated was excessive and unlawful (and to recover past overpayments from that reduced allowance).

Based on the same analysis as that set out above relating to treating overpayments as "administrative expenses", we conclude that shifting recoupment of overpayments from those who received them to members who have not yet retired would also constitute a diversion of trust funds prohibited by ORS 238.660.

In sum, the provisions of HB 2003 would shield employers entirely, and current retirees for the most part, from the cost of any Board actions ultimately found to be unlawful in the Marion County litigation. HB 2003 would instead charge those costs to future Fund earnings as an administrative expense and shift recovery of overpayments from those who received them to other PERS memebers. This would contravene the existing PERS pension plan in four ways: (1) The bill would result in a new retirement allowance for some money match retirees in excess of that authorized by ORS 238.300; (2) It would supercede ORS 238.715, which would otherwise obligate the Board to recover unlawful benefits from the recipients; (3) It would pay the costs with Fund earnings as an administrative expense contrary to ORS 238.610; and (4) It would constitute a diversion of trust funds contrary to ORS 238.660.

B. Are The Terms Contravened By HB 2003 Part Of The State's Contract With PERS Members?

As before, we begin with the proposition that a PERS contract exists. *Hughes,* 314 Or at 18. As described above, ORS 238.300, 238.610. 238.660 and 238.715 would be altered by HB 2003. The question is whether ORS 238.300, 238.610, 238.660 and 238.715 are part of that contract.

ORS 238.300 provides that a retiring PERS member "shall receive a service retirement allowance which shall consist of the following annuity and pension." ORS 238.610 (1) provides that PERS administrative expenses "shall" be paid from Fund income. ORS 238.610(4) provides that retirement allowances "shall not for any purpose" be deemed Board expenses. ORS 238.660 declares PERF to be a trust fund, declares the Board to be trustee with fiduciary obligations, and provides that Fund assets "may not" be directed or used for other than the exclusive benefits of members. Moreover, there can be no more fundamental components of an investment-based pension plan than the rules governing how fund assets are to be used; how investment earnings are to be allocated; how the amount of a member's retirement benefits are to be determined; and that members are to benefit from their contributions' increase in value. And while the PERS plan does not promise to allocate to members' accounts any specific amount or percentage of Fund's earnings, apart from the assumed interest rate, the distribution of Fund earnings is undeniably a "zero-sum game." If overpayments to certain PERS members can be recovered from funds that otherwise would be credited to other members' accounts, then those other members have clearly lost retirement benefits they otherwise would have received. For those reasons, we believe the Supreme Court would

find that ORS 238.300 238.610, and 238.660 governing the distribution of earnings, setting the retirement allowances for members, and prohibiting the diversion of assets are part of the PERS contract.

ORS 238.715 was enacted into law by the 1993 Legislative Assembly, which directed that it be added to the PERS chapter and be applicable to post-enactment overpayments. Or Laws 1993, ch 119. That statute gives four explicit assurances to recipients of overpayments, all of which appear to be in the nature of promises: The two restrictions on the recovery of overpayments discussed above (ten percent maximum on reduction of monthly payment and six year limitation on recovery) and the requirement that the Board give advance notice of its intention to recover the overpayment and provide the member with an opportunity to appeal the determination. ORS 238.715 also grants the Board rights adverse to the member: The right to recover interest at one percent per month, and collection costs including attorney fees, if the overpayment results from the recipient's intentional or fraudulent act. Neither would otherwise be available to the Board, as nine percent per year is the rate of interest assessed on overdue debts "if the parties have not otherwise agreed to a rate of interest," ORS 82.010, and attorney fees are not recoverable in a collection action absent a contract or statute so providing, *Mattiza v. Foster,* 311 Or 1, 4, 803 P2d 723 (1990). But the assurances provided to overpayment recipients by ORS 238.715 are incidental to the statute's core purpose, which is the recovery of overpayments. For that reason, ORS 238.715 also implicitly promises all PERS members and all participating public employers that retirees will receive the benefits to which they are lawfully entitled, but no more, and that PERS will take whatever steps are necessary to recover overpayments so that employees and other members are not damaged as a result. We believe that the Supreme Court would find ORS 238.715 to be part of the PERS contract.

Finally, we find nothing in the text or context of the statutes relevant to this question to indicate that they could not be changed in the future with respect to earnings on contributions and benefits that accrue because of work performed after the effective date of the bill. HB 2003, however, would adversely affect benefits for work already performed. Consequently, HB 2003 violates current PERS members' contract rights under both *Hughes* and *OSPOA.*

C. Breach or Impairment

As it relates to your fourth question, HB 2003 would not amend or repeal any elements of the current PERS contract; it would simply disregard the terms discussed above. For that reason, HB 2003 would constitute a breach, instead of an impairment of contract. The state potentially would be liable for the damages of members adversely affected.

Our analysis of this question does not depend on the assumed interest rate guarantee, and our conclusions are therefore no different for Tier One and Tier Two members.

Sincerely,

Hardy Myers
Attorney General

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[1] Your questions were received before HB 2003 was amended and ultimately passed by the Legislative Assembly. Throughout this letter, we refer to the provisions of Enrolled HB 2003 as enacted. HB 2004 also was amended and enacted into law between your request and the date of this letter. Throughout this letter, we refer to the provisions of Enrolled HB 2004 as enacted.

[2] Each of the questions addressed in this opinion focuses on the contractual nature of PERS and whether changes to PERS by proposed legislation would constitute an unconstitutional impairment of that contract. Public employee claims filed in response to prior attempts to alter PERS have argued not only that the attempted amendments impaired the PERS contract, but also that they constituted a taking of property without just compensation in violation of Article I, section 18 of the Oregon Constitution. *See, e.g., Hughes,* 314 Or at 33-34. Two commentators have suggested that courts should recognize that public employees possess a protected property interest in accumulated funds. PUBLIC EMPLOYEE PENSIONS IN TIMES OF FISCAL DISTRESS, 90 Harvard Law Review 992; NOTE, 'TIL DEATH DO US PART: PENNSYLVANIA'S 'CONTRACT' WITH PUBLIC EMPLOYEES FOR PENSION BENEFITS, 59 Temple Law Quarterly 553 (1986). The Oregon Supreme Court, as noted in the text, has explicitly analyzed these issues under the contract clauses of the Oregon and United States Constitutions. Therefore, like the questions posed, the opinion focuses on issues raised by the contractual nature of PERS.

[3] While characterizing PERS as a contract between the state and public employees, the Oregon Supreme Court has also recognized that individual entities of the state in their role as employers, *e.g.*, a school district, a city or the state itself, are responsible for the contractual commitments made by the legislature's enactment of statutes that form part of the PERS contract. *Stovall v. State,* 324 Or 92, 123, 128, 922 P2d 646 (1996).

[4] Justice Van Hoomissen wrote the majority opinion for the court. Justice Fadeley joined the majority opinion, but also wrote a separate concurrence. Justice Gillette, joined by Justices Carson and Graber, wrote a separate opinion specially concurring in part and dissenting in part.

[5] Analysis under the federal impairments clause is largely consistent with that used under Article I, section 21 of the Oregon Constitution *See Does 1, 2, 3, 4, 5, 6, and 7 v. State,* 164 Or. App. 543, 562-563, 993 P.2d 822 (1999) citing *Eckles,* 306 Or at 395-398 ("For the most

part, the analysis * * * of the Oregon constitutional protection against impairment of the obligation of contracts is parallel to the federal analysis"). Ways in which federal and state analysis differs arise once an impairment is found. *See Hughes*, 314 Or at 35 fn 39 (determining whether state law violates federal Contracts Clause includes consideration of whether public purposes justify the impairment). The Oregon Supreme Court has noted that it may be unwilling to apply the "balancing" founded by modern Federal Court interpretations of the U.S. Constitution to the analysis of Article I, section 21 of the Oregon Constitution. *Hughes*, 314 Or at 14 fn. 16.

[6] While we have presented our understanding of the legislature's intent in drafting HB 2004, alternative interpretations may be offered due to ambiguities in Section 4(1) of the bill. Subsection 1 is imprecise in that it requires the Board to "use" actuarial equivalency factors based on September 10, 2002 mortality assumptions, but, unlike Section 3 of the bill, it does not specifically require the Board to adopt new actuarial factors. While it appears that the Board must adopt new factors to carry out Section 4(1), it appears to be left to its discretion as to when to adopt such factors during the period from the effective date of the bill through July 1, 2003. If the Board adopted new factors effective prior to July 1, 2003, it would affect all calculations under Section 4(3), for employees retiring both before and after July 1, 2003. Because subsection 1 states that the Board is to use factors based on the 2002 assumptions "for the purpose" of calculating retirement allowances for employees retiring between July 1, 2003 and January 1, 2005, we conclude that the best interpretation of subsection 1 requires the Board to adopt new actuarial factors based on the 2002 mortality assumptions to be effective beginning July 1, 2003.

Section 4(1) is also ambiguous in its use of the introductory clause "[s]ubject to subsections (2) and (3) of this section* * *." Reading subsections 1 through 4 together, it appears that the legislature's intent is for the Board to use one set of actuarial factors in calculating an employee's retirement allowance under subsection 2 and a different set of factors for the calculation stated in subsection 3. To comply with such an intent, the actuarial factors referred to in subsection 1 would apply only to the subsection 2 calculation. This interpretation would be clear if the introductory language in subsection 1 referred only to subsection 3, *i.e.*, "subject to subsection (3) ***," or, alternatively, referred only to subsection 2, *e.g.*, "for purposes of subsection (2) ***." The fact that the introductory language refers to both subsections 2 and 3 raises the possibility that the actuarial factors established by the Board under subsection 1 are to apply to both calculations, making the calculation under subsection 3 superfluous for employees retiring before 2005. We think the more reasonable reading of those provisions is that they call for separate sets of actuarial factors to be used in the subsection (2) and subsection (3) calculations as set out in the text.

[7] Death benefits would be calculated using the actuarial factors in effect on the due date of the first payment. HB 2004, § 4(5).

[8] We are aware of no reason to anticipate that life expectancy figures will decrease in the foreseeable future.

[9] The lawyer for one of the plaintiffs in *City of Eugene v. State of Oregon*, has asserted that "The attorney general has concluded that board practices and rules cannot create

permanent contract rights." Letter from Bill Gary to Senator Tony Corcoran and Representative Tim Knopp (March 26, 2003). Respectfully, we disagree. The document relied upon for that assertion cannot fairly be construed to support that conclusion.

[10] *See also Assoc. Oregon Veterans v. DVA*, 300 Or 441, 450, 712 P2d 103 (1985) ("This court has not held that a state agency possesses 'reserved' or 'inherent' power to modify contracts to which it is a party whenever, in the opinion of its responsible officials, such modification will further the interests of the citizenry. We decline to do so here. Whatever reserved power exists lies in the state, that is, the legislature, and the people").

[11] Our goal in interpreting a statute is to determine the intent of the legislature. *PGE v. Bureau of Labor and Industries* (*PGE*), 317 Or 606, 610, 859 P2d 1143 (1993); ORS 174.020. We start by examining the text and context of the statute, with the text being the best evidence of legislative intent. In interpreting the text, we consider statutory and judicially developed rules of construction that "bear directly on how to read the text," such as "not to insert what has been omitted, or to omit what has been inserted," and to give words of common usage their plain, natural and ordinary meaning. *PGE*, at 611; ORS 174.010. The context of a statute includes other provisions of the same statute, prior versions of the statute and other related statutes, as well as case law interpreting those statutes. *PGE*, at 610; *SAIF Corporation v. Walker*, 330 Or 102, 108, 996 P2d 979 (2000); *Krieger v. Just*, 319 Or 328, 336, 876 P2d 753 (1994); *Ecumenical Ministries v. Oregon State Lottery Comm.*, 318 Or 551, 560 n 8, 871 P2d 106 (1994). If the text and context of a statute unambiguously disclose the intent of the legislature, the inquiry almost certainly will end there; though parties may offer legislative history to assist a court in construing a statute, the court will only give it the weight the court considers appropriate. ORS 174.020. If the legislative intent is not clear from the text and context, the court will look to legislative history to attempt to discern that intent. *PGE*, at 611-12; *see Young v. State*, 161 Or App 32, 983 P2d 1044, *rev den* 329 Or 447 (1999).

[12] The dictionary definition of "manage," as the legislature has used it in relation to the Board, is "to direct or carry on business or affairs : SUPERVISE, ADMINISTER." WEBSTER'S THIRD NEW INT'L DICTIONARY (1993) at 1372.

[13] After enactment of ORS 238.630(3)(g) and the Board's adoption of OAR 459-005-0055, the legislature made clear its intent that the Board act to protect PERS' qualified status. In 1995, the legislature obligated the Board to "adopt rules and take all actions necessary to maintain qualification of the Public Employees Retirement System and the Public Employees Retirement Fund as a qualified governmental retirement plan and trust under the Internal Revenue Code and under regulations adopted pursuant to the Internal Revenue Code." ORS 238.630(3)(h) as amended by Or Laws 1995, ch 296, § 5. Also, in 1999, the legislature added a second section to ORS 238.650 stating that "[a]ll rules adopted by the board become part of the written plan document of the Public Employees Retirement System for the purpose of the status of the system and the Public Employees Retirement Fund as a qualified governmental retirement plan and trust under the Internal Revenue Code and under regulations adopted pursuant to the Internal Revenue Code." ORS 238.650(2) as amended by Or Laws 1999, ch 317, § 1.

[14] There are a number of factors that must be taken into account in defining the pre-change accrued benefit. For example, certain PERS members are eligible to obtain increased

benefits by purchasing one or more credits for certain periods of service such as military service or the member's six-month waiting period for initial eligibility. In some cases, those credits would need to be added to the accrued benefit.

[15] As to the calculation of benefit payments for employees who joined PERS on or after January 1, 1999, what the Board's rule protects from alteration is treatment of accrued benefits. By its own terms, the rule permits the Board to apply new actuarial factors to benefits accrued subsequent to the effective date of the establishment of the new factors.

[16] ORS 238.601 states the legislature's intent that the Board "shall administer the system to create and maintain long-term stability and viability in the system, and shall act to achieve full funding for the benefits provided by the system." While this statement may reflect on the legislature's intent to authorize the Board to commit the state to certain actions with regard to the use of actuarial factors, the statute was not enacted until 2001, several years after the legislature enacted ORS 238.630(3)(g). *See* Or Laws 2001, ch 945, § 2.

[17] In deciding that the PERS Board "has acted improperly in refusing to update its mortality tables and has abused its discretion in failing to follow the legislative mandate to maintain 'actuarial equivalency' when determining retirement benefits," The circuit court characterized the legislature's intent for the establishment of actuarial factors as follows:

> It is apparent from the use of strikingly similar language throughout the operative statutes that the legislature placed substantial importance on the maintenance of "actuarial equivalency" in establishing members' retirement benefits on a parity with their contributions. In implementing this legislative policy, the Board is charged with monitoring changes in members' mortality and establishing "from time to time" the necessary actuarial factors to maintain that "actuarial equivalency" with the assistance of its actuary. ORS 238.605 and ORS 238.630(3)(g). The legislature's use of the verb "shall" only serves to emphasize the mandatory nature of this directive.

City of Eugene v. State of Oregon, Marion Co. Cir. Ct. Case No. 00C16173, October 7, 2002 Opinion and Order at 14-15.

[18] In 1955, the legislature added authority for the PERS Board to transfer funds collected from employer contributions to carry out the actuary's recommendation and, in 1987, required that the actuarial evaluation be conducted every two, instead of four, years. *See* Or Laws 1955, ch 131, § 20; Or Laws 1987, ch 849, § 3.

[19] HB 2003 does not actually eliminate the money match formula. However, as a result of the changes in HB 2003, many future retirees ultimately will receive the greater life pension under the full formula method of calculating retirement benefits.

[20] For example, any employee who would receive a greater retirement benefit under the "full formula" refund would not be adversely affected by the provision of HB 2004 eliminating the employee contribution.

[21] Or Laws 1971, ch 738, § 2.

[22] Or Laws 1973, ch 695, § 4.

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[23] The legislature adopted ORS 238.255 (then numbered ORS 237.277) in 1975. Or Laws 1975, ch 333, § 2. The statute was amended in 1993 and 2001. Or Laws 1993, ch 177, § 31; Or Laws 2001, ch 945, § 4. Neither amendment materially altered the "assumed interest rate" earnings requirement.

[24] Under the Board's rules, a "Tier One member" is a "member who established in the system before January 1, 1996, as defined in ORS 238.430(2)." OAR 459-005-0001(14). "Tier Two members" are those "established" in the system after January 1, 1996. OAR 459-005-0001(15). Tier Two members do not receive the annual "assumed interest rate" earnings credit under ORS 238.255. ORS 238.435(4).

[25] ORS 238.255, as amended by section 1, chapter 3, Oregon Laws 2003 (HB 2001) provides:

> (1) The regular account for an active or inactive member of the system shall be examined each year. If the regular account is credited with earnings for the previous year in an amount less than the earnings that would have been credited pursuant to the assumed interest rate for that year determined by the Public Employees Retirement Board, the amount of the difference shall be credited to the regular account and charged to a reserve account in the fund established for the purpose. A reserve account so established may not be maintained on a deficit basis for a period of more than five years. Earnings in excess of the assumed interest rate for years following the year for which a charge is made to the reserve account shall first be applied to reduce or eliminate the amount of a deficit.
>
> (2) The regular account for an active or inactive member who established membership in the system before January 1, 1996, as described in ORS 238.430, may not be credited with earnings in excess of the assumed interest rate until:
>
> (a) The reserve account established under subsection (1) of this section no longer has a deficit;
>
> (b) The reserve account established under subsection (1) of this section is fully funded with amounts determined by the board, after consultation with the actuary employed by the board, to be necessary to ensure a zero balance in the account when all members who established membership in the system before January 1, 1996, as described in ORS 238.430, have retired; and
>
> (c) The reserve account established under subsection (1) of this section has been fully funded as described in paragraph (b) of this subsection in each of the three immediately preceding calendar years.

[26] We previously described the process for establishing the assumed interest rate as follows:

> This assumed interest rate, we understand, is not set for any specific year or period of years. That is, it is not a prediction that in 1977 the fund will earn X percent

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> interest on its investments. Rather, it is a prediction that based upon current interest rates, economic trends so far as they can be foreseen, etc., the fund will for so much of the future as can be foreseen earn at an overall rate of X percent per annum. This 'assumed interest rate' would certainly be exhaustively re-evaluated at least every four years as a part of the quadrennial actuarial review in detail required by [*former* ORS 237.285, now ORS 238.605]; and it would appear proper for the board to adjust the assumed rate at any other time changed conditions require a change in assumptions as to future interest rates.

38 Op Atty Gen 880, 887 (1977). Due to a 1977 amendment to former ORS 237.825 (now ORS 238.605), the formerly quadrennial actuarial review now takes place every two years. *See* Or Laws 1987, ch 849, § 3.

[27] We previously reached the same conclusion. In 1992, there was a proposal to freeze the guaranteed minimum rate of return at 8.0 percent and to "decouple" it from the actuarial assumed interest rate. In the course of concluding that such an amendment would impair non-retired PERS members' contractual rights in violation of Article I, section 21, of the Oregon Constitution, we said:

> Because the guaranteed minimum is part of the PERS law and affects the level of benefits to PERS members, we conclude that the guaranteed payment of earnings to members' accounts provided by ORS 237.277 is part of the PERS members' retirement contract.

Letter of Advice to Sheryl Wilson, Director of PERS, November 25, 1992, (OP-6293, 1992 WL 526815).

[28] The purpose of the 1975 enactment of former ORS 237.277 was to "insure that PERS members will receive earnings that are at least equal to the assumed interest rate earned by the system." *See* Minutes, Joint Committee on Ways and Means (HB 2507), May 29, 1975, at 310.

[29] Previously, we concluded that ORS 238.255 promises that, so long as an individual account exists, the minimum amounts credited will be the assumed rate. Letter of Advice to Sheryl Wilson, Director of PERS, November 25, 1992 (OP-6293, 1992 WL 526815). In that opinion, we did not discuss any distinction between the second and third categories of rights discussed above (*i.e.*, future credits on contributions or earnings thereon from work occurring before any change in the assumed interest rate promise *and* future credits related to contributions or earnings related to work occurring after a change). That analysis did not focus with sufficient precision on the specific promises set out in ORS 238.255.

[30] ORS 174.010 provides:

> In the construction of a statute, the office of the judge is simply to ascertain and declare what is, in terms or in substance, contained therein, not to insert what has been omitted, or to omit what has been inserted; and where there are several provisions or particulars such construction is, if possible, to be adopted as will give effect to all.

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[31] The case challenging the Board's action is on appeal and the authoritative answer to whether the Board's disputed actions were, in fact, unlawful will be determined by the Court of Appeals or the Supreme Court, absent settlement or dismissal.

[32] The preamble to HB 2003 describes the Board's errors as follows:

> (a) Unlawfully using outdated mortality tables to calculate retirees' monthly benefits; (b) Unlawfully requiring employers to match earnings in the employees' variable accounts when those employees' pensions are calculated under the "money match formula"; and (c) Unlawfully abusing its discretion in failing to set aside adequate statutorily mandated reserves out of investment income while crediting imprudently large amounts of investment income to member accounts[.]

[33] Section 10 of HB 2003 provides:

> (1) Notwithstanding ORS 238.360, cost of living increases for that portion of a service retirement allowance that is not attributable to a variable annuity under ORS 238.260 and that is payable to or on account of members described in subsection (5) of this section may be made only as provided by this section.
>
> (2) The Public Employees Retirement Board shall calculate a revised service retirement allowance for that portion of a service retirement allowance that is not attributable to a variable annuity under ORS 238.260 and that is payable to members described in subsection (5) of this section. The revised service retirement allowance shall be calculated as follows:
>
> (a) The board shall establish a member account balance for the member as of the member's effective date of retirement, determined as though the regular member account for the member had been credited with 11.33 percent earnings in calendar year 1999.
>
> (b) The board shall calculate a service retirement allowance for the member under ORS 238.300 as of the member's effective date of retirement, using the member account balance established under paragraph (a) of this subsection.
>
> (c) If the member elected an optional service retirement allowance calculation under ORS 238.305, the board shall convert the service retirement allowance calculated under paragraph (b) of this subsection to the optional calculation elected by the member.
>
> (d) The board shall adjust the revised service retirement allowance calculated under paragraph (b) or (c) of this subsection for each calendar year after the member's effective date of retirement based on the cost of living adjustment provided for in ORS 238.360.
>
> (3) The board shall calculate a fixed service retirement allowance for members described in subsection (5) of this section. The fixed service retirement allowance shall be the amount that is not attributable to a variable annuity under

ORS 238.260 and that is payable to or on account of the member on the effective date of this 2003 Act. The fixed service retirement allowance may not be adjusted under ORS 238.360.

(4) The service retirement allowance payable to or on account of members described in subsection (5) of this section shall be the greater of the revised service retirement allowance calculated under subsection (2) of this section or the fixed service retirement allowance calculated under subsection (3) of this section.

(5) The provisions of this section apply to members who:

(a) Established membership in the Public Employees Retirement System before January 1, 1996, as described in ORS 238.430;

(b) Receive a service retirement allowance calculated under ORS 238.300 (2)(b)(A); and

(c) Have an effective date of retirement that is on or after April 1, 2000, and before April 1, 2004.

[34] In relevant part, ORS 238.660(1) and (2) state:

(1) The Public Employees Retirement Fund is declared to be a trust fund, separate and distinct from the General Fund, for the uses and purposes set forth in this chapter and ORS 237.950 to 237.980, and for no other use or purpose, except that this provision shall not be deemed to amend or impair the force or effect of any law of this state specifically authorizing the investment of moneys from the fund. Interest earned by the fund shall be credited to the fund. Except as otherwise specifically provided by law, the Public Employees Retirement Board established by ORS 238.630 is declared to be the trustee of the fund. * * *

(2) Until all liabilities to members and their beneficiaries are satisfied, assets of the fund may not be diverted or otherwise put to any use that is not for the exclusive benefit of members and their beneficiaries. * * *

[35] PERF "earnings" include interest. *See, e.g.*, ORS 238.250 and 238.255 (discussing "interest" earned by member accounts). ORS 238.660(1) specifies that "[i]nterest earned by the Fund shall be credited to the fund." Thus, it is undisputable that HB 2003 contemplates the use of PERF assets.

[36] The statutes in ORS chapter 128 governing trusts do not apply to trusts that have as their primary purpose the paying of pensions. ORS 128.005(1).

[37] ORS 238.715 provides in relevant part:

(1) If the Public Employees Retirement Board determines that a member * * * has received any amount in excess of the amounts that the member * * * is entitled to under

this chapter, 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.

* * * *

(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.

* * * *

(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.

APPENDIX

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RECEIVED
JUN 02 2003

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May 19, 2003

Hardy Myers, Attorney General
State of Oregon
Department of Justice
1162 Court Street N.E.
Salem, Oregon 97301-4096

Subject: Public Employees Retirement System

Legislative Change in Actuarial Factors

Dear Attorney General Myers:

Request For Opinion. This letter responds to the federal tax qualification portion of the first question presented in Senator Tony Corcoran's March 5, 2003, letter request for a number of opinions about pending Oregon Public Employees Retirement System ("PERS") legislative issues. His first question asks: "Does the 'look back' provision of HB 2004A adequately protect members' contract rights as well as assure the continued qualification of the PERS plan by the IRS?" We are not providing any opinion on the state law protection of the contract rights portion of that question, except to the extent the federal tax qualification portion relates to that contract rights portion. We understand that the change and the "look back" provision is now in a later engrossed version of that bill, and our opinion extends to later versions and other bills as well, to the extent the provisions are the same.

Earlier Opinions. Our October 31, 2002, letter regarding the PERS board's change in actuarial factors was that complying with the October 7, 2002, Marion County Circuit Court decision did not give PERS a defense against it being income tax disqualified by the Internal Revenue Service ("IRS"). In our September 9, 2002, letter, we defined what was included in the PERS "accrued benefit" for federal tax qualification purposes. In both of those letters, we gave no opinion on whether it would tax disqualify PERS if any portion of the change date accrued benefit was not preserved on a change in the actuarial factors, the so-called "anti-cutback" rule. The State received a November 21, 2001, opinion from then legal counsel, that if the IRS was asked to rule on an actuarial factors change that had the effect of reducing the accrued benefit, it would more likely than not rule against the tax qualification of such a change.

Summary Opinion. We cannot say with certainty whether the proposed change in actuarial factors will or will not income tax disqualify PERS. We do not take issue with the analysis in the earlier legal opinion received by the State, but conclude differently that there is a reasonable likelihood that the IRS would rule in favor of the continued tax qualification of PERS with such change. Because the tax qualification of PERS is at stake in any such change, our opinion is conditioned upon PERS seeking IRS approval. **We strongly recommend that the actuarial factors change be made contingent upon IRS approval** and that such approval be sought immediately after this legislative change is enacted so that PERS is within the remedial amendment period should any corrective legislation be needed. Because the nature of the change is a reduction in benefits, there should not be any administrative risk to PERS tax qualification in implementing the change pending IRS consideration. If the IRS determined that the change would tax disqualify PERS, then the condition of the change would not be met, and the prior benefit differential from the change date to the IRS determination date could be paid to the members.

Explanation of Opinion. The legal authorities are set forth in the November 21, 2001, opinion of prior legal counsel. We have not found any later authorities.

We raised this issue with Dick Wickersham, the IRS chief technical advisor, whose opinion would be important in its decision on this matter, and who was consulted by prior legal counsel. Nothing that Mr. Wickersham communicated to us is binding on the IRS. We asked him very specifically whether an actuarial factors change, which retroactively reduces accrued benefits, would violate the Internal Revenue Code ("Code") Section 401(a)(25) or the IRS Regulation § 1.401-1(b)(1)(i) definitely determinable benefit rule. We told him we could not determine the answer. Even though he agrees there is no clear answer to this issue, his sense was that an actuarial factors change would be acceptable to the IRS based on a combination of the law and practicality. The "look back" approach included in HB 2004A mitigates to some extent the effects of the changes in the factors and would apply to that practicality. Mr. Wickersham thought that the change would not be tax disqualifying when weighing the strictures of the "definitely determinable benefits" requirement and the fact that the Code Section 411 accrued benefit "anti-cutback" does not apply to a governmental plan. He suggested that a governmental plan request a determination letter on any such amendment to receive a definitive answer.

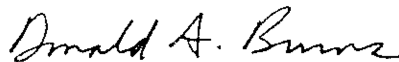
Code Section 401(a)(25) is violated if a plan's actuarial assumptions, which must be set forth in the Plan, are subject to employer discretion. In IRS Private Letter Ruling 9645031, the IRS concluded in that governmental plan fact situation that "the power of the Retirement Board to amend the plan to change the interest rate crediting mechanism does not mean that the benefits provided under the Plan are not definitely determinable * * *" because that board did not effectively have the prohibited discretion under Code Section 401(a)(25). As with any IRS private letter ruling, the contents of that ruling cannot be relied upon by other taxpayers as authority, however, IRS private letter rulings are not the work of a single person and

that ruling is strong support for concluding that the IRS is reasonably likely to approve the pending change.

Prior legal counsel discussed in his opinion, IRS Revenue Rulings 79-90 and 81-12. We did not find the single reference in the preamble to the Code Section 401(a)(4) regulations that Code Section 401(a)(25) affirms the IRS position in those Revenue Rulings, to be dispositive. Had Congress meant the Code Section 411(d)(6) anti-cutback rule to apply to a governmental plan by adding Code Section 401(a)(25), it would have been simple drafting to do so. Code Section 401(a)(25) virtually codified Revenue Ruling 79-90 and PERS has and will continue to comply because the actuarial factors will be specified in the plan, which includes the board's rules. The mere power to amend the factors could not be the prohibited employer discretion as all plans can be amended. Revenue Ruling 81-12 relates solely to the Code Section 411(d)(6) anti-cutback rule, which clearly does not apply to a governmental plan like PERS.

Arguably, the case for there not being the prohibited employer discretion and the benefits being definitely determinable is even stronger in the present case where the Oregon Legislative Assembly is directing the PERS board to use the tables it considered last September and to adopt tables every two years using the best actuarial information available on mortality as provided by the board's actuary, which may be in conjunction with the statutorily required system evaluation. The legislative process and those restrictions on changes in the actuarial tables are not akin to the employer discretion that would violate Code Section 401(a)(25) and the IRS Regulation Section 1.401-1(b)(1)(i) definitely determinable benefits requirement.

Very truly yours,



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