

February 6, 2003

The Honorable Tim Knopp
Chairman
House Committee on Public Employee Retirement System
900 Court Street NE H-295
Salem, OR 97301

Re: Constitutionality of Implementing Updated
Actuarial Equivalency Factors

Dear Representative Knopp:

Thank you for the opportunity to address your committee on the subject of updating actuarial equivalency factors for use in calculating retirement allowances under the PERS system. The purpose of this letter is to explain why the Legislature can direct the PERS Board to adopt and apply updated mortality tables without violating the contract rights of PERS members. To do so, this letter responds to the contrary argument previously presented to the Committee by Greg Hartman, legal counsel for the PERS Coalition. Simply put, public employers have no contractual obligation to pay retirement benefits that are based on inaccurate or outdated mortality tables.

At the outset, it must be acknowledged that the Oregon Supreme Court has held unequivocally that some provisions of the PERS statutes embody contractual promises by participating employers to their PERS member employees. Great care must be taken whenever the legislature considers modifying provisions of the PERS statutes to account for these contractual obligations. It also is virtually certain that any meaningful reform of the PERS system will be attacked on the ground that it is a breach of contract and challenged in court on that basis. It does not follow, however, as counsel for the PERS Coalition has suggested, that any measure that has the effect of reducing projected future PERS benefits is unlawful. The PERS system, as it has been administered by the PERS Board, is not hermetically sealed from legislative oversight by some vague concept of contract rights. No court decision has armed PERS members with a contract rights trump card that insulates PERS Board practices from scrutiny and protects member expectations no matter how unreasonable and unfounded those expectations may be.

On the contrary, a meaningful analysis of PERS member contract rights must begin with a careful analysis of precisely what contractual promises the Legislative Assembly has made. That inquiry, in turn, must focus on whether the legislature intended for a statutory provision to be a contractual promise. In the case of actuarial equivalency factors, nothing in the PERS statutes remotely suggests that the legislature intended to make a promise that old mortality tables would always be applied to calculate member retirement benefits, no matter how outdated those tables become. In fact, ORS 238.300(1) expressly provides the opposite. It states that the members' benefit "shall be the actuarial equivalent of accumulated contributions by the member and interest thereon credited at the time of retirement." That is the benefit that the legislature has provided. PERS's actuary has acknowledged that the continued application of outdated mortality tables produces a member benefit that is greater than the statutory actuarial equivalent.

That is the reason that the Marion County Circuit Court, following a two-week trial, ordered the PERS Board to implement the use of current and accurate mortality tables "immediately and fully." Although the petitioners in that case directly challenged the PERS Board's continuing use of outdated mortality tables for calculating retirement annuities, neither the State nor the intervenors—PERS members represented by the PERS Coalition's counsel—claimed that ordering the use of current mortality tables would be a breach of contract. In other words, Mr. Hartman never argued in court as he has before this committee, that the continued use of outdated mortality tables is contractually required. The fact that Judge Lipscomb's ruling was not challenged by either the State or the intervenors on contract grounds is legally significant. It means that the ruling cannot be attacked on appeal based upon a contract rights argument. But the fact that able counsel, in hard fought litigation, did not even attempt to convince the court that the use of outdated mortality tables is contractually required is also a telling comment about the weakness of that position.

Following is an explanation of the current state of the law as it applies to the statutory provision for the use of current mortality tables in calculating a member's annuity upon retirement. Nothing in the law prohibits the Legislature from requiring the PERS Board immediately to implement the use of current mortality tables. In fact, the current PERS statutes already require it.

The Scope of PERS Contract Rights

Any consideration of whether a proposed statute would violate the PERS contract must begin with this threshold question: what are the terms of the PERS contract? Mr. Hartman concedes that this is the central question and that, with respect to mortality tables, it has not yet been decided by the courts. However, he concludes without analysis that it is "inconceivable" that actuarial factors would not be found to be contractual. Mr. Hartman's statement is not supported by the law. The statutory language does not promise a benefit based on outdated

actuarial factors, and the PERS Board's practices do not, and cannot, create contractual obligations on the part of the State. Regardless of the pronouncements from other jurisdictions, inaccurate mortality factors would be a contractual obligation of the State of Oregon *only if* the Legislative Assembly intended to make such a promise by enacting statutory language to that effect.

Legislative intent

Not every statute creates a contractual obligation on the part of the State. In *Hughes v. State*, 314 Or 1, 838 P2d 1018 (1992), the Oregon Supreme Court emphasized that "a contract will not be inferred from * * * legislation unless it unambiguously expresses an intention to create a contract." We know that the PERS statutes create certain contractual obligations on the part of the State and public employers. In order to know the *terms* of that contract, however, one must look to the particular language of the PERS statutes and identify the legislature's unambiguous intent as to each purported contractual provision.

The first question is this: what contractual promise, if any, did the Legislature intend to make with regard to the use of mortality tables to calculate a member's annuity upon retirement? The relevant statute here is ORS 238.300, which provides the formula for calculating the standard service retirement allowance. Subsection (1) describes the refund annuity portion of the calculation, "which shall be the *actuarial equivalent* of accumulated contributions by the member and interest thereon credited at the time of retirement * * *." (Emphasis added.) The statutory language could not be more clear—it *directs* the PERS Board to calculate a member's monthly annuity based on the member's expected life span at the time of his or her retirement. This statutory directive can be accomplished only if the calculation is made using current and accurate mortality tables at the time the amount of the annuity is determined. As the Marion County Circuit Court found, the PERS Board's longstanding practice of using outdated mortality tables violates this statutory directive.

The PERS statutes as they currently exist demonstrate an unambiguous legislative intent that the PERS Board regularly adopt current actuarial equivalency factors and apply current factors when computing monthly benefits for retirees. Nothing in the statutes requires the PERS Board to use 1978 mortality tables. Nothing in the statutes or legislative history provides a scintilla of evidence that the Legislature intended to promise PERS members that their annuities upon retirement would be calculated with outdated mortality tables, thereby promising them larger retirement benefits than the system is designed or funded to support.

The PERS Coalition argues that the PERS "contract" requires the Board to apply the mortality tables in place at the time an employee was first hired when calculating the refund annuity. The common sense error in that argument is obvious: using actuarial factors from that point in time to calculate benefits at the time of retirement makes no more sense than it would to

use the member's accumulated contributions (\$0) at the date he or she first became employed. Common sense dictates that the key factors in determining a proper monthly benefit allowance under the refund annuity are: (1) how much principal and interest has accumulated in the member's account; and (2) how long the member is expected to live after the date of retirement. Mortality tables in place on the member's service date are irrelevant to that determination, and there is no evidence whatsoever that the Legislature intended such an absurd result.

If there is a contract right with regard to mortality tables, it can be only that members are entitled to have their annuities determined by the use of current mortality tables. There is no language in the statutes that suggests that a member is entitled to the use of more generous factors. The plain language and practical application of the PERS statutes' terms regarding actuarial factors clearly and unambiguously require the regular adoption of current actuarial factors and the use of up-to-date mortality tables when computing retirement benefits. Doing so does not impair or breach the contractual obligations of PERS employers—it enforces them.

The City of Eugene Decision

For many years, the PERS Board's practice has been to apply inaccurate mortality tables to calculate members' annuities when doing so would produce a larger monthly benefit than the current tables. In *City of Eugene v. State*, Case No. 99C12794, eight local governments challenged that practice as contrary to statute. Judge Paul Lipscomb of the Marion County Circuit Court concluded that the Board's practice was erroneous and ordered the PERS Board to implement the use of current mortality tables "immediately and fully." After describing the PERS Board's statutory obligation to adopt and apply current actuarial factors, Judge Lipscomb assessed the Board's behavior as follows:

"It is the conclusion of this Court that the 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. None of the justifications and rationalizations offered by the Board are sufficient to excuse the Board's persistent refusal to implement this part of the statutory scheme except when it would benefit employee members. Neither fear of litigation by employees, nor a concern for a potential challenge by the Internal Revenue Service is a sufficient basis for ignoring the Board's own statutory obligations as established by the legislature.

"* * * The Board has a duty to comply with the statutory mandate immediately and fully." Opinion and Order dated October 7, 2002.

The Marion County Circuit Court has declared that the PERS Board's practices with respect to actuarial equivalency factors over the last 25 years have been contrary to the Board's statutory obligations. In response to the petitioners' allegation that the Board's use of outdated mortality tables was illegal, neither the State nor the intervenors—PERS members raised any claim that updating those tables would breach any contract right. Thus, the question of whether the court's order requiring the Board immediately to implement current mortality tables breaches members' contract rights has not been preserved for appeal. The court's ruling on this issue is the law.

A particularly flagrant example of the Board's improper conduct is its adoption in 1993 of OAR 459-005-0055, which states that no new actuarial factors will be adopted for active participants if they would result in a diminution of the value of monthly pension benefits. As Judge Lipscomb ruled, that practice is impermissible. Some might argue that the PERS Board, by adopting OAR 459-005-0055, created a new and separate contractual obligation on the part of the State to honor the Board's policy of never adopting new actuarial factors if doing so would result in smaller monthly benefits. Oregon law rejects such a contention. The State is not bound by a promise made by a State agency that the agency may not lawfully make or perform. The Oregon Court of Appeals, in *Harsh Investment Corp. v. State*, 88 Or App 151, 158, 744 P2d 588 (1987), stated the law as follows: "Those who deal with state officers must know the extent of their authority and cannot claim by estoppel what they could not receive by contract." Judge Lipscomb's ruling leaves no doubt that the PERS Board's actions in adopting OAR 459-005-0055 and in using outdated mortality tables have been in violation of state law, making them unenforceable as contractual obligations. Simply stated, the Legislature, not the PERS Board, has the power to make contractual promises to PERS members. The PERS Board cannot create contract rights by ignoring or misconstruing the Legislature's statutory directives.

Law from Other Jurisdictions

Despite the clear statutory mandate requiring the Board to adopt and use current mortality tables and Judge Lipscomb's order enforcing those statutes, the PERS Coalition has suggested in its testimony that doing so would violate the contractual rights of PERS retirees. As we have demonstrated, the Coalition's position, as expressed in Mr. Hartman's January 28, 2003 written testimony, is unsupported by Oregon law. The Coalition also relies on the law of other jurisdictions to support its position, but that law does not control the actions of Oregon's Legislative Assembly. Mr. Hartman cites two cases for the proposition that PERS cannot use current actuarial equivalency factors "to diminish the benefits of existing participants without a breach of the pension contract." Those cases are *Sheffield v. Alaska Public Employees Association*, 732 P2d 1083 (Alaska 1987) and *Birnbaum v. New York State Teachers Retirement System*, 176 NYS2d 984 (NY 1958). These cases are controlled by the peculiarities of Alaska

and New York law, respectively. Neither case is controlling authority in Oregon and both are inconsistent with Oregon law.¹

In both *Sheffield* and *Birnbaum*, the courts' decisions were governed by provisions in their respective state constitutions that expressly prohibit the reduction of public employee retirement benefits.² The Oregon Constitution has no comparable provision.

¹ The Oregon Court of Appeals has rejected the theories advanced in *Sheffield* and *Birnbaum*. *Hart v. Washington County Rural Fire Protection District No. 1*, 52 Or App 1005, 630 P2d 390 (1981); *Adams v. Schrunk*, 6 Or App 580, 488 P2d 831 (1971).

² The *Sheffield* court's analysis was governed by the following provision in from Article XII, section 7 of Alaska's constitution:

“Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired.”

Mr. Hartman also has suggested that the continued use of outdated mortality tables may be required by virtue of a federal consent decree entered into 25 years ago between PERS and female public employees. *Henderson v. State of Oregon*, US District Court (Oregon) Case No. 74-538 (1978). In that case, PERS agreed to discontinue its use of gender-specific mortality tables for men and women after it was asserted that the practice constituted sex discrimination. That suggestion reads far too much into the terms of that stipulated settlement. The plaintiffs in Henderson claimed that PERS was discriminating against them by using mortality tables that accounted for the fact that women, as a group, typically live longer than men. The effect of this practice was that women, with the same years of service and the same account balances as men, received lower monthly benefits. In the Henderson consent decree, PERS agreed to discontinue its use of gender specific mortality tables. The court in Henderson was not concerned with what specific mortality tables were used, it was concerned only that the mortality tables did not discriminate between men and women. It is not reasonable to read anything more into the settlement of that case.

The Internal Revenue Code

Mr. Hartman also has suggested, without elaboration, that federal tax law may prohibit any diminution in a member's accrued pension benefit. That suggestion is misleading and incorrect – PERS is not subject to the Internal Revenue Code provisions cited by Mr. Hartman.

The *Birnbaum* court's decision was governed by Article V, section 7, of the New York Constitution which provides as follows:

“After July first, nineteen hundred forty, membership in any pension or retirement system of the state shall be a contractual relationship, the benefits of which shall not be diminished or impaired.”

PERS is designed to comply with the pension plan tax qualification standards of the Internal Revenue Code (the "Code"). 26 U.S.C. Section 401, et seq. As part of these qualification standards, Code Section 411(d)(6) generally prohibits an amendment to a plan that causes a reduction in any participant's accrued benefit. PERS, however, is a "governmental plan" as defined by Code Section 414(d) (i.e., a plan "established and maintained ... by the government of any State..."). In this regard, Code Section 411(e)(1) holds that the provisions of Code Section 411 do not apply to a governmental plan. Moreover, in IRS Private Letter Ruling 9645031 (August 16, 1996), the IRS applied this legal principle to allow the Retirement Board of a pension plan similar to PERS to modify the plan's benefit calculation assumptions. In allowing the change, the IRS expressly stated that because the plan was a governmental plan, it was not subject to the provisions of Code Section 411(d)(6) that otherwise prohibit reductions in a participant's accrued benefit.

Accordingly, notwithstanding any insinuations to the contrary, the Internal Revenue Code does not preclude the implementation of current mortality tables for the purpose of calculating a member's annuity upon retirement, even if the updated tables reduce the amount that a member expects to receive from PERS.

Practical Impact of Outdated Mortality Tables

The use of outdated mortality tables in violation of state law has contributed heavily to the system's precarious financial condition, and threatens to have a growing impact as advances in health care extend life expectancy at an ever-increasing rate. Since the Board last updated its tables in 1978, life expectancy has increased by approximately four years. Therefore, on average, a PERS member retiring today will receive four years' worth of benefits in excess of the actuarial equivalent value of their contributions to the system and the interest they have earned on those contributions. The difference between the aggregate benefit to which the retiree is statutorily entitled and the benefit he or she actually receives must be paid for by the public employer.

The impact of the use of outdated mortality tables can be illustrated by an example using a hypothetical PERS member retiring with a money match benefit. This member will get an annuity based on her account balance at the time of retirement and a matching pension from employer contributions. If accurate mortality tables are used and the member lives exactly as long as predicted by those tables, the member and employer will each have provided half of the total benefit paid – in the attached example, \$1502 per month from each source, for a total of \$3004 per month. But if mortality is underestimated, this equal sharing of costs will not occur. Instead, the employer will pick up the difference. For instance, if 1978 tables are used, the monthly benefit will be higher – \$3200 per month – and the member's account balance will be

exhausted when the retiree reaches the average age of 1978 mortality. Every payment made from that point forward – 48 more months, on average – will be funded entirely by employer (i.e., taxpayer) contributions. In other words, for the first 22 years, the employer pays 50% of the benefit, and for the final four years, the employer pays 100% of the benefit. See attached diagram illustrating this example.

ORS 238.300 clearly reflects the legislature's intention that when a PERS member retires under the "money match" option, the cost of the member's benefit will be borne equally by the member's account and by the contributions of the member's employer. Calculating a monthly benefit using accurate actuarial equivalency factors maintains this balance. Using outdated mortality tables increases the member's total benefit and 100% of the cost of that increase is borne by the taxpayers. The legislature did not intend that result. Therefore, PERS members do not have a contractual right to insist upon that result.

Very truly yours,

William F. Gary

WFG/gb
Enclosure