IN THE SUPREME COURT OF THE
STATE OF OREGON

In the Matter of the Consolidated	)	*Strunk*	X	**S50593 (Control)**
Public Employee Retirement	)	*Burt*	X	S50647
Systems (PERS Litigation)	)	*Dahlin*	X	S50645
	)	*Evans*	X	S50532
	)	*Petrillo*	X	S50687
	)	*Sartain*	X	S50686
	)	*Whitty*	X	S50685
	)			
	)			

AMICUS CURIAE BRIEF OF
ASSOCIATED OREGON INDUSTRIES
OREGON BUSINESS ASSOCIATION
OREGON BUSINESS COUNCIL, AND
PORTLAND BUSINESS ALLIANCE

Continued on reverse....

June 2004

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I. INTRODUCTION

A. Interest of Amici

Associated Oregon Industries, the Oregon Business Association, the Oregon Business Council and the Portland Business Alliance respectfully submit the following amicus brief. Our four business associations, which have never participated together in a court proceeding, want to alert the Court that the stakes involved in this case involve nothing less than Oregon's economic health and the ability of government to provide public services in the future.

On December 9, 2002, over 1300 business, community, and elected leaders came together at the Oregon Convention Center to support and discuss the newly created Oregon Business Plan, a plan aimed at strengthening Oregon's economy. Those in attendance overwhelmingly endorsed reform of PERS as the *number one* priority for the Oregon Business Plan. The reason was simple. Without PERS reform, our state faced an unprecedented fiscal calamity. No state in the nation had a more structurally flawed pension system than Oregon. To cover an unfunded liability of over $17 billion over the next 25 years, public spending reductions totaling hundreds of millions of dollars *per biennium* would need to be implemented. Without these corrections the economic health, social well-being, and quality of life of our state will be impacted severely, and the prospect of the state or local entities declaring bankruptcy within 10 years is a very real possibility.

Oregon businesses need public services to be competitive. Schools provide critical skills. The transportation system is vital for moving products. The court system is critical to facilitate commerce. Oregon's quality of life enables business to attract critical talent. As the

2003 Legislature convened, the rapidly escalating costs of PERS put essential public services and Oregon's economic future at risk.

B. The Clash of Titanic Principles and the Need for Careful Doctrinal Balancing

This public employee pension case presents the clash of two titanic policy values foundational to our political and legal culture. On the one hand, our free market economic system, our laws, and our culture stand behind the ancient idea that "promises [are] to keep."[1] On the other, the liberty won in the American War of Independence (and preserved in our federal and state constitutions) must include the power of the people to adjust the costs and structures of their own government.[2] These competing policy values cast their reflections on many of the legal doctrines entwined in these pension cases: the concept of "total compensation," the concepts of "accrued" and/or "vested" pension benefits, the strong presumption against construing statutory promises to curtail the ability of future legislatures to address future contingencies, and the doctrine that even an impairment of a governmental contract may be allowed where reasonable and necessary to important public purposes. Thus, this case calls not merely for the application of legal doctrine to the facts presented, but for a careful and nuanced balancing of these competing policy principles.

The parties understandably present single-minded perspectives on this clash – that this is an easy case about keeping promises, or an easy case about the people's liberty via their

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[1] Robert Frost *The Poetry of Robert Frost* 225 (Edward Connery Lathem ed., 1st ed., Henry Holt and Company, 1975).

[2] Joyce Appleby, *Capitalism and A New Social Order: The Republican Vision of the 1790's* 16-23 (New York University 1984). Professor Appleby identifies three strands of liberty that concerned the Founders: (1) classical, positive Republican liberty to self-govern as a community, (2) the historical negative liberty of "rights" against kingly (or governmental) infringement of secure possessions and personal freedom, and (3) the Lockean or liberal concept of liberty that focuses on the instrumentalist purposes of government to foster growth and economic production via individual initiative, markets, and private ordering.

elected representative to rein in the excesses and costs of government. But, for the Supreme Court, these clashing values rooted deep in our legal and political culture must be reconciled.

The choices are complicated and wrenching. On the one hand, undeniably, the Reform Legislation cuts billions of dollars from the projected future pension benefits of public employees.[3] On a human level, real people – dedicated public safety officers, teachers, clerks, and highway and maintenance workers – will often have to make do monthly on hundreds of dollars less[4] than the retirement benefits they had been expecting based on statements from union officials and attorneys and the PERS bureaucracy itself.

On the other hand, without such reductions in expectations, a subset of future public employee retirees (i.e. "Tier One" – pre-1996 hires with substantial account balances) would continue to receive "Cadillac" pensions in excess of their own final governmental salaries.[5] And, as there is no free lunch, the dollars necessary to fund these Cadillac pensions for a diminishing group of "lucky" Tier One employees would have to be diverted from taxpayers and businesses, or from vitally needed educational, public safety, transportation, and "safety net" services, and/or from the compensation of other deserving public employees generally,

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[3] HB 2003 and HB 2004 (herein the PERS Reform Legislation), according to Special Master David Brewer, cuts PERS unfunded liability by $8.5 billion. Special Master, p. 75-76. The size of the cuts can be taken either as a measure of legislative severity (as the Tier One PERS beneficiaries understandably view it) or as a measure of the generosity or excesses of the pre-reform system.

[4] In a few cases the monthly effect falls between $1,000-$2,000. This again can be viewed either as a measure of the severity of the reductions, or of the unreasonable generosity and excess of the system before the reforms.

[5] "In 2000, the average PERS retiree with 30 years of service retired at age of 53 with an allowance equal to 106 percent of the retiree's final average salary." Special Master, p. 14. Pension income of about 75% of final working income, <u>counting</u> social security, is a common goal of many systems. The PERS "full formula" benefit (which most employees were expected to take until the 1990's boom) provided for 50% of final average salary after 30 years of service.

including the majority of public employees who would *not* receive "windfall" pension benefits.[6]

Moreover, the reform legislation carries implications beyond pensions and governmental budgets and services. America is – and for some years has been – in the midst of a "tax revolt." A majority or near-majority of the electorate persistently distrust the efficacy and efficiency of governmental spending,[7] and in many cases, the institutions of government themselves.[8] The PERS Reform Legislation resulted from a bipartisan majority (Governor Kulongoski and Democratic legislative leaders joining with Republican leaders in the Senate and House of Representatives).[9] The Governor and Legislative leadership sought not only to restore confidence in the PERS system, but in the processes of representative and

[6] Numerous articles and editorials demonstrate the public's great concern with the inability to sufficiently fund essential state programs, due to the overly generous nature of the PERS system, especially for Tier One employees. *See e.g.*, Tim Knopp, *In my Opinion Legislature Must Achieve PERS Reform*, The Oregonian (Sunrise Ed.) (January 30, 2003) (available in LEXIS, News Library); Steve Mayes, *New Faces in the House*, (Sunrise Ed.) (January 23, 2003) (available in LEXIS, News Library); Editorial, *Cutting PERS Down to Size*, The Oregonian (Sunrise Ed.) (February 16, 2003) (available in LEXIS, News Library); Editorial, *Same Crisis in Suburban Schools*, The Oregonian (Sunrise Ed.) (February 22, 2003) (available in LEXIS, News Library).

[7] According to an April, 2003, NPR/Kaiser Family Foundation/Kennedy School of Government poll, a majority of Americans (52%) believes that so much is wrong with the federal tax system that Congress should completely overhaul it. National Public Radio, *Americans' Views on Taxes*, http://www.npr.org/news/specials/polls/taxes2003 (accessed June 2, 2004). According to a 1998 survey conducted by Pew Research Center for People & the Press, 64% of Americans agree that when a program is run by the government, it is usually inefficient and wasteful. Pew Research Center for the People & the Press, *How Americans View Government*, http://people-press.org/reports/print.php3?PageID=593 (accessed June 2, 2004).

[8] The Court may take judicial notice of the failed Oregon referenda for income tax surcharges in both 2002 and 2003.

[9] *See e.g.*, Dave Hogan, *Committee Backs PERS Reforms*, The Oregonian (Sunrise Ed.) (April 25, 2003) (available in LEXIS, News Library); Dave Hogan, *House Approves Plan to Overhaul PERS*, The Oregonian (Sunrise Ed.) (May 3, 2003) (available in LEXIS, News Library); Dave Hogan, *Reform of PERS Barrels Forward*, The Oregonian (Sunrise Ed.) (May 8, 2003) (available in LEXIS, News Library).

deliberative government itself.[10] For Oregon to regain the unity it needs to support necessary governmental services and a tax structure necessary for a favorable business and job generation climate, there must be confidence in how the government compensates its employees and in governmental ability to address problems as they arise. The PERS Reform Legislation sought to help restore that trust, and for that reason, is supported by Oregon's business community.

II. A PENSION PRIMER: PRIVATE SECTOR ERISA AND SOCIAL SECURITY PENSIONS

A. Private Pension - ERISA

The content of the PERS pension contract can only be understood by examining the law and practices governing private-sector pensions. Most taxpayers are employed in the private sector. The Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 (2003), governs pension benefits for most private-sector employees.

The ERISA pension framework for private sector workers sets forth fundamentals relevant to all retirement schemes. First, ERISA does not require that private sector employers maintain a pension plan; as a consequence, many private sector employees do not receive pension benefits.[11] Second, under ERISA, benefits "accrue" as they are earned

[10] A January 12, 2003, article in The Oregonian announced Governor-elect Kulongoski's self-described "mandate to...restore public confidence in Oregon's government." In the article, Governor-elect Kulongoski was quoted, "The problem is, we haven't been truthful . . . We always tell the public the sky is falling . . . and we always find a way to get by. The public doesn't believe us any more . . . I have to prove to them, this government is smart, it's productive, it's using its money wisely and it's making the right choices." Harry Esteve, *Lawmakers Strapped for Cash, Credibility*, The Oregonian (Sunrise Ed.) (January 12, 2003) (available in LEXIS, News Library). Public confidence in the PERS system, in particular, had dissipated to the point where municipalities simply refused to join the system. David R. Anderson, *Forest Grove Rejects Plan for Option to Join PERS; City Council Members Decides the State Retirement System's Future is Too Uncertain for Municipal Employees Now*, The Oregonian (Sunrise Ed.) (January 15, 2003) (available in LEXIS, News Library).

[11] *See* John H. Langbein & Bruce A. Wolk *Pension and Employee Benefit Law* (3d ed.,

through service, but still may be forfeited by termination of service or otherwise, until they "vest" under the provisions of the pension plan or the vesting rules in ERISA. Third, ERISA establishes two types of pension plans, "Defined Benefit Plans" (DBP) and "Defined Contribution Plans" (DCP), each with their own allocation of the risks of investment gain or loss.

"Defined Benefit Plans" are traditional pension plans which pay a retirement benefit based on a formula – usually involving years of service. In DBPs employers make contributions to a trust fund that invests the contributions; the contributions and earnings on the contributions (if earnings are as "assumed") will create a fund barely adequate to pay the defined benefit for each employee from retirement to death (assuming the employee dies "on schedule" under the relevant mortality tables).[12] In a DBP, the risk of investment gain or loss falls on the employer. If the "assumed" earnings are not realized, a deficit (unfunded actuarial liability or *UAL*) will arise, and the employer must make good any shortfall with additional contributions. Conversely, if actual earnings exceed the "assumed" earnings on contributions and the trust generates a surplus, the excess funds in the pension trust belong to the employer. *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439-441 (1999). Note that in a private-sector DBP, the risk of investment gain or loss falls symmetrically on one party, who accepts both the upside and downside possibilities. Finally, in a DBP, a trust faced with inadequate funding may make cuts in benefits that affect pension accrual for prospective service only; any already earned ("accrued") and "vested" benefits must be preserved.

Found. Press 2000). Professors Langbein and Wolk report that in 1991, only 55% of the non-agricultural work force enjoyed an employer-sponsored pension plan. *Id.* at 26.

[12] A defined benefit may also be paid out as a joint and survivor annuity. In that case the benefit may continue not only for the life of the employee, but also for the life of a spouse. Of course, the monthly benefit is reduced to reflect the payout period.

During the booming 1990's DBPs fell somewhat out of favor, and many employers adopted Defined Contribution Plans (DCPs) which often were popular with employees.[13]

In contrast, "Defined Contribution Plans" reverse the risk of investment gains or losses. In a DCP, the employer promises, not a defined benefit, but a defined, certain contribution placed by the employer and, at times by the employee, into the employee's individual pension account, (often a percentage of salary). When the employee reaches retirement, she receives the amounts contributed together with all net earnings. Thus, DCPs operate much like Individual Retirement Accounts (IRAs). The DCP employee reaps the rewards when investment gains are good, as in the 1990's when returns often exceeded 15%. But when the investment cycle turns downward, as in the period 2000-2002, the employee with a DCP may see startling *declines* in account values due to negative investment results in the DCP. Note, once again, the risks of gain or loss are fixed symmetrically – the same party (this time the employee) that enjoys the upside investment potential carries the downside investment risk in a DCP.

As shown below, as administered until 2003, PERS combined characteristics of both DBPs and DCPs and placed all the risks on public employers. And it was just this feature of PERS that led to the "PERS Crisis" of 2002-03.

B. Social Security Pensions

Social Security pensions are completely non-contractual, and the federal government remains free to modify benefit structures at any time. *Fleming v. Nestor*, 363 U.S. 603, 610-611 (1960). This is fortunate since, given the demographics of the "baby boom" generation and those that followed, there will be a much smaller ratio of active workers paying into the

[13] Langbein & Wolk, *supra*, note 11 at 55-57.

social security system compared to retirees receiving benefits in the future. Reduction in benefits (in some form) or new taxes for social security are inevitable. Already many younger workers do not see their interests as adequately served by the social security system. The present PERS litigation, with its obvious conflicts in interest between older Tier One employees and younger employees hired since 1996, may be on the front edge of a wave of disputes presenting intergenerational conflict.

C. Pension Plan Administration

Regardless of the type of pension system, critical discretionary decisions of pension administration are inherent in any scheme. Pension plan administrators must select an accurate mortality table that will permit a stream of benefits to flow to retirees for their entire lives. Administrators must create and direct investment earnings to a reserve fund large enough to fund pensions in lean years when earnings are not adequate to cover the inevitable outflow of pension benefits. *See, e.g.*, ORS 238.255 (mandating transfer to member accounts from a reserve account when earnings are less than assumed earnings rate). The plan administrator also sets employer contribution rates and adopts actuarial factors. Special Master, p. 8. These actions by pension administrators are acts of a discretionary nature, hopefully accomplished with a high degree of actuarial expertise, that occur regularly on an ongoing basis. They are actions of pension professionals that typically may be delegated by contract or legislation.[14]

[14] These administrative actions of fiduciaries express no clear and unambiguous legislative intention that such conduct could become immutable terms of the PERS contract – even as to future services and future earnings.

III. PERS EVOLVED GRADUALLY OVER TIME INTO A HYBRID, RUBE GOLDBERG SYSTEM FULL OF BELLS AND WHISTLES AND AN UNSTAINABLE COST AND BENEFIT STRUCTURE

A. The Problem – The Unsustainable Hybrid DBP and DCP Features In PERS Operations Prior To The PERS Reform Legislation

As PERS[15] evolved over the years, it developed hybrid characteristics that contained elements of both Defined Benefit and Defined Contribution plans. Unlike the private-sector plans governed by ERISA, however, PERS did not maintain a "symmetrical" allocation of the risks of investment gain and loss to either the employer (as in DBPs), or the employee (as in DPCs). Instead, as operated PERS mixed these DBP and DCP characteristics, saddling public employers (and taxpayers) with the risk of investment losses while giving employees much of the upside gains.

In summary, it was PERS *as it was administered* that gave its Tier One employee beneficiaries both the best of a DBP (a guaranteed benefit even when there were investment losses) and the best of a DCP (upside investment gains). Thus the risk of loss and stake in gains was not allocated symmetrically in PERS, as they are in the typical private retirement system.

This hybrid system was destined for disaster. No financially sound pension plan can allow employees to participate in the investment gains, but not the losses. As Representative MacPherson, who led the reform effort for the Democrats in the House of Representatives, aptly put it: The system was "mathematically flawed. . . . When you

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[15] In this brief, the term "PERS" is used to describe the pension system. Of course, PERS operated via the decisions and actions of its Board and officers. In many places in the text, the term PERB (meaning the system's Board of Directors) would be appropriate. We have often chosen to use a consistent reference to "PERS" even though "PERB" would be more precise.

make the average [return] a floor, an unfunded liability is inevitable." James Mayer, *Cap on PERS Account Growth Passes House Unanimously*, The Oregonian (Sunrise Ed.) (Jan. 30, 2003) (available in LEXIS, News Library). All that was needed for disaster was a few high earnings years, in which employee account balances were pumped up unreasonably, followed by a few years of zero or negative earnings.[16] And that is exactly what unfolded over the five years preceding the Reform Legislation. This Amicus brief now turns to the numbers.

B. The Numbers Tell the Story

1. The Numbers: PERB's Unreasonably Generous Allocation of Earnings To Risk Free Member Accounts And Grossly Inadequate Allocations to Reserve Accounts

Two distinguished judges – Judge Brewer and Judge Lipscomb – have looked at this dispute and both have found or recommended findings that PERB's allocations of earnings were unreasonable, arbitrary, and an abuse of discretion. (Special Master, p. 56; Special Master p. 58, noting Judge Lipscomb's ruling in the *City of Eugene* case). Although PERS earned an average of 14.75% between 1990 and 2000 (and an average of over 21% in 1995-1999 (Special Master, p. 26)), and although the non-variable risk free accounts were only guaranteed a return of 8%, when earnings plunged in the period 2000-2002, PERS possessed insufficient reserves to continue paying an "8% guarantee"

[16] Another easily anticipatable circumstance would have been a decade or so of very modest earnings (say 0-5%) below the 8% assumed earnings rate guaranteed to employee accounts. For example, between 1969 and 1982, the Dow Jones Industrial Average remained remarkably level. In 1969, on May 14, the Dow Jones Industrial Average registered its annual *high* of 968.85. On December 27, 1982, the Average reached its annual high at 1070.55. In other words, between May 14, 1969, and December 27, 1982, the Dow Jones Industrial Average gained an average of 7.82 points per year, for an annual return of less than one percent for an entire decade. Apparently — less than 20 years later — this history had been forgotten by PERB. *The World Almanac and Book of Facts*, 2004 125 (William A. McGeveren, Jr. *et al* eds. World Almanac Books 2004).

without running up a huge unfunded actuarial liability (UAL). By the winter of 2003, during the Legislative Session, the UAL reached *$17 billion.* Special Master, p. 22. Given that an income tax surcharge referendum (designed to raise *a few hundred MILLION* for the maintenance of public services) failed decisively in the winter of 2003, a PERS deficit that had grown from *$1.5 billion to $17 BILLION* (Special Master p. 22, 31) in just two years understandably generated tremendous concern to legislators and the public alike.[17]

How could PERS earn so much money in the 1990's and wind up in 2003 with a huge actuarial deficit? The answer lies in the hybrid DBP-DCP features of PERS as it was administered by PERB prior to the Reform Legislation: "Tier One" beneficiaries fully shared years of high investment gains far in excess of an assumed earnings rate, yet were insulated from investment losses in their non-variable and risk free accounts. One can see graphically the "can't lose" position of PERS Tier One beneficiaries, as the system was administered by the Board until 2003, in the following chart (numbers set forth are taken directly from the Special Master's Recommended Findings, p. 25, 27-32):

[17] Tim Knopp, R-Bend, who joined Governor Kulongoski in leading the bipartisan effort to create the Reform Legislation, said of the UAL, "If we don't do something, taxpayers will be even more outraged. People are going to be retiring at 200 percent plus. The public's not going to go for that." Dave Hogan, *Payouts on PERS May Swell Even More*, The Oregonian (Sunrise Ed.) (April 9, 2003) (available in LEXIS, News Library).

Allocation of Earnings to Member And Reserve Accounts

Year	Earnings by %	Dollar Allocation to Gain-Loss Reserve	Dollar Allocation to Contingency Reserve	Allocation to Risk Free Employee Non-Variable Accounts By % of Account
1989	19.74%	$506 million	0	14.5%
1990	-1.63 (loss)	Reduction of $892 million	0	8%
1991	22.45%	$762 million	0	15%
1992	6.94%	Reduction of $126 million	0	8%
1993	15.04%	$398 million	0	12%
1994	2.16%	Reduction of $851 million	0	8%
1995	20.78%	$1.2 billion	0	12.5%
1996	24.42%	$601 million	0	21%
1997	20.42%	$395 million	0	18.7%
1998	15.63%	$321 million	0	14.1%
*1999	24.89%	$1.3 billion	0	20%
2000	.63%	Reduction of $2 billion	0	8%
2001	-7.36% (loss)	Reduction of balance of reserve -$610 Reserve Deficit	0	8%
2002	-8.22% (loss)	0 in G-L Reserve. New 2.2 billion reserve deficit.	0	8%

* The 20% allocation of 1999 Earnings was found by Judge Lipscomb to be an abuse of discretion in the *City of Eugene* case, Special Master, p. 58. Judge Lipscomb's decision did not review allocations prior to 1999.

a. Allocations to Risk Free Accounts

As graphically shown above, between 1990 and 2000, PERS earned an average of 14.75% on its investments, and credited an average of 13.63% to Tier One non-variable accounts not subject to downside risk. 13.63%, with no downside risk, was a recipe for disaster even in the booming 1990's. In the five years starting in 1995, PERS earned an average of 21%, and credited the risk free employee non-variable accounts with an average 17.2% gain. Yet, while exuberantly allocating earnings to employees' risk free accounts, PERB ignored or underfunded its statutory and fiduciary duty to provide adequate reserves. Far too little was set aside in mandatory reserve accounts for the market turn that was as inevitable as the return of rain in Oregon.

b. The Miniscule (Or At Best Inadequate) Gain-Loss Reserve Mandated by ORS 238.670(3)

First, PERS' own gain-loss reserve was inadequate and in violation of statutes. The Special Master rightly recommends the Supreme Court find PERB was unreasonable and imprudent in failing to maintain a Gain-Loss Reserve sufficient to cover at least 30 months of guaranteed earnings at 8% in the event of zero investment returns. Special Master, p. 56-57. Amazingly, the Board actually reduced its goal from 24 months to 18 months (while never reaching it) for the Gain-Loss Reserve in 1996. Special Master, p.29. Though PERB restored the goal of a Gain-Loss Reserve sufficient to cover 30 months of zero earnings as the roof began to crack in February of 2000, it never, despite its fantastic 1990's earnings, reached its own goal. Special Master, pp, 31, 57.

And even PERS' own 30 months reserve goal (at zero earnings) was patently inadequate. As the table above reveals, PERS' own experience in 1990 and 1994 showed that even returns in the plus or minus 2% range could, given PERS's application of the 8%

guarantee, trigger demands on the Gain-Loss Reserve approaching $1 billion. Further, the huge earnings run-up in 1995-1999 (average 21% gain) surely must have suggested to prudent fiduciaries that eventually the markets would have to correct with substantial losses.[18] In fact, the 3-year period 2000, 2001, and 2002 resulted in net losses of almost 15%. This constituted an actual actuarial shortfall of nearly 41% given the 8% guarantee (8% compounded over 3 years plus the 15% loss). It was hardly prudent in a pension system not to *plan* more adequately for years with significantly negative or low gains; certainly this was a significant and reasonably foreseeable possibility.

c. <u>Zero Balance In Contingency Reserve</u>

While it severely underfunded the "Gain-Loss Reserve" (ORS 238.670 (3)), PERB completely ignored its separate obligation under ORS 238.670 (1) to fund a "Contingency Reserve" in amounts up to 7.5% of earnings "to prevent any deficit in retirement allowances due to interest fluctuations, changes in mortality rate or ... other contingency." Thus when the "rainy day" investment losses began in 2000, PERS had zero in its statutorily-mandated contingency fund.[19]

Given that any year with earnings of less than 8% is a deficit year under the PERB practice of guaranteeing 8% *each year*, it was imprudent, to say the least, not to consider the *possibility* of exhausting the modest and underfunded Gain-Loss Reserve. And with no

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[18] Between 1969 and 1982 the Dow Jones Industrial Average, for example, rose on average less than 1% a year. Apparenetly this history was forgotten at PERB only a decade later. *See* footnote 16.

[19] ORS 238.670(1) provides that in any year in which earnings equal or exceed the assumed interest rate ... the board *shall set aside* ... such part of the income as the board may deem advisable, not exceeding 7½% ... The Board shall continue to credit the reserve account ... until the board determines that the reserve account is adequately funded for the purposes specified in this subsection .... to prevent any deficit of moneys available for the payment of retirement allowances, due to interest [i.e. earnings] fluctuations, changes in mortality rates, or ... other contingency." (emphasis added).

mandatory Contingency Reserve at all, there was no cushion when the market inevitably corrected.[20]

2. The Numbers: The Magic of the "Money Match"

As ably explained in the Non-State Defendants' Hearing Memorandum at p. 9-17, the PERS statute evolved gradually, piece by piece, over four decades rather than as the product of one single grand design. As it evolved, a seemingly innocuous provision was added in 1969 to aid a small number of public employees.[21] Years later this provision acted synergistically with PERS's unreasonably generous allocations of earnings to greatly increase, in a matter certainly not anticipated by the 1969 Legislature, employee retirement benefits and governmental costs. This provision was the "Money Match."

The "Money Match" is an alternative benefit calculation to the "Full Formula" benefit. The "Full Formula" benefit is a traditional Defined Benefit Plan (as with private sector plans governed by ERISA), with the system and employers carrying both the risk of investment losses and the upside potential of investment gains. Under a DBP such as the "Full Formula," the employee, so long as the pension fund is fiscally sound, is not directly affected by short term investment gains or losses. The employee benefit is determined by a defined calculation that often includes such things as years of service and salary. Under

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[20] PERS also maintains a "BIF" (Benefits In Force) Reserve for its obligations to already retired members. Special Master, p.19.

[21] As stated by the Special Master, after some changes in 1968 to the original structure of PERS, "PERB [in 1969] recognized that one or two members .... received lower benefits [under the 1968 changes] than they would have received under the previous system..." Special Master, p. 11-12. The Legislature, believing only a few employees would benefit, restored the feature of the orginal PERS – a provision that the employer would match any accumulated contributions by employees into their own retirement accounts (plus earnings) at retirement. The "Money Match" was thus reborn in 1969, but laid, for all but a few employees, dormant for years. Most employees retired under other options, which starting in 1981 became the "Full Formula" benefit (yielding 50% of final salary after 30 years of service). Not until 1997 did PERS actuary – in calculating future system pension liabilities – even consider the Money Match.

PERS, the "Full Formula" benefit is officially designed to generate a pension of 50% of final salary (not counting social security) for an employee retiring after 30 years of service. This "defined benefit" resulted from the "Full Formula" calculation which is simply years of service times 1.67% times final average salary for most PERS beneficiaries.

The "Full Formula" 50% "replacement ratio" of the pension to final average salary is a common goal for pension plans and was an intended goal of PERS. Special Master, p. 12. Social Security provides another 20-35% for most workers, and the combination generates the 70-85% of final salary generally deemed sufficient to maintain a standard of living after retirement. Special Master, p. 15.

Until the mid-1990's the "Full Formula" was the most common benefit received by PERS retirees, and was the basis for the pension benefit estimates sent annually to the employees. But as the 1990's unfolded, more and more retiring employees elected the "Money Match"; it often yielded dramatically higher benefits. In fact, when PERS first began assuming a "Money Match" election as the basis for its annual pension account estimates sent to employees in 1998: "For many members . . . . projected monthly retirement allowances [were] in amounts *more than TWICE those shown on the previous year's statement.*" Special Master, p. 25 (emphasis added).

How did the "Money Match" create this dramatic increase in projected (and actual) retirement benefits – and the resulting dramatic rise in costs to the public employers? The answer is: "Money Match" began to operate synergistically with the rapidly rising employee account balances generated by PERS' generous allocations of earnings to employee accounts. That is because "Money Match" gives employees the option to reject the "Full Formula"; the retiree instead receives an annuity equal in value to TWICE the accumulated contributions and net earnings in the employees' risk free, high yield individual accounts. Effectively, for example, the 21% gain allocated to the risk free accounts in 1996 (*See* Table, *supra* p.12) gave the employees a whopping 42% gain (since the 21% eventually had to be "matched"). Put simply, the employee takes all accumulations in her account, and then an employer must "match" these accumulations – and it is this doubled or "Money Matched" account balance on which the employee's retirement benefit is calculated. Whether this unintended consequence of an amendment, thought at the time to have limited effects upon a modest number of employees, constitutes an immutable promise with respect to pension earnings from future service is a major issue in this case.

3. The Icing On the Cake: The Use of Outdated Mortality Tables to Inflate the Monthly Pension Payment Even Higher

The prior subsections explain how PERB's unreasonable and imprudent allocations of bountiful 1990's investment returns, coupled with the magical doubling of those highly compounded returns via the "Money Match," led to lump-sum benefits far beyond those necessary to generate the 50% replacement of salary ratios envisioned in the legislatively established "Full Formula." But when employees retired, PERB converted the inflated lump-sum benefits generated by the high account balances and "Money Match" to life pensions using outdated mortality tables. PERB therefore gave employees retiring under these outdated mortality tables a larger monthly pension benefit than they had earned, even with the generous allocations to individual account balances and the "Money Match." By understating the probable length of retirees' lives using outdated mortality tables, PERB gratuitously allowed retirees to receive a larger monthly payment and breached its fiduciary duty. When retirees live beyond the ages predicted by the outdated tables, they continue receiving unearned monthly pension benefits until death and the extra cost is absorbed by the system, or added to the unfunded actuarial liability. The Special Master found that the use of the outdated tables cost the system about 2.28% of payroll in higher contribution rates. Special Master, p. 39.

4. The Numbers: Exploding Unfunded Actuarial Liability and Sharply Rising Governmental Contribution Rates In The Midst of A Tax Revolt And A Widespread Disaffection From All Levels And Branches of Government

Until 2001, public employer PERS contribution rates never exceeded an average of 11.84% of payroll. Special Master, p.40. But then PERB's failure to maintain adequate reserves caught up with the system.

The final official valuation report prior to the 2003 Legislative Assembly proposed increases in employer contributions averaging 4.82% of payroll. Special Master, p.43. While at first blush that might not seem large – expressed as a percentage of payroll – an increase from 11.5% to 17.25% of payroll amounts to an increase in percentage terms of almost 50%. These increases were implemented during the Legislative Session. Special Master, p. 43.[22]

Each 1% increase in average contribution rates systemwide costs about $65 *million* based on Judge Brewer's finding of system-wide total payroll of $6.5 *billion*. Special Master, p. 20. Thus the rate increases adopted just prior to the PERS Reform Legislation immediately added about $300 million to the budget deficit facing the 2003 Legislature. That deficit started as a $2 billion shortfall from a "current services" level, a deficit which grew almost another $1 billion during the session due to continuing falloffs in tax revenues.

There was only one place to find the necessary money to balance the budget, and that was in further service cuts above the hundreds of millions already cut from budgets, and

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[22] 4.82% is the correct number for comparison purposes because the rest of the increase from 11.5% to 17.25% reflected an accounting change. Special Master, p. 43

cutting salary and benefits offered to public employees generally. In the state service, for example, Governor Kulongoski proposed a wage freeze for state employees. With some minor modifications, the Governor's wage freeze stuck.[23] This episode illustrated that, far from a battle between public employees and the forces of reaction, the current controversy involves as much as anything conflicting interests among public employees. No employee hired since 1996 benefits by the diversion of scarce "total compensation" dollars to fund "Cadillac Pensions" for a sub-set of lucky Tier One employees.

As unsettling as the actual 2003 public employer rate increases were (based on actuarial studies through 2001), the bad news was just beginning. PERS staff, in the Winter of 2003 as the Legislative Assembly deliberated the Reform Legislation, "projected that, by 2007, employer contribution rates would likely increase to 25% of payroll" and remain at that level for "years to come." Special Master, p. 44. This would be more than double the rates that existed only 2 years earlier. Special Master, p. 44. At about $70 million per 1% of rate increases (assuming some growth in PERS system-wide payroll due to inflation), something on the order of one-half billion dollars more in total contributions per biennium would be necessary to pay for these projected further increases. Special Master, p. 20, 44. And this would be an *ongoing* added cost.

And though 2003 investment returns eventually proved stellar, no one was sanguine at the time of a quick rebound. (And regardless of any person's risk aversion, fiduciaries can not merely pray for the best.) As Judge Brewer pointed out, even with a 24% investment gain in 2003, *and with the Reform Legislation left intact by the Supreme Court,* contribution rates

[23] *See* Norm Maves Jr. and James Mayer, *Public Employees Union Has Deal*, The Oregonian (Sunrise Ed.) (June 30, 2003) (available in LEXIS, News Library) (reporting that 17,400 state workers will see a two-year wage freeze but keep health care benefits under a new contract).

would still remain at the 15-17% of payroll level "for at least for the next 20 years." Special Master, p. 75. Since Judge Brewer found that the Reform Legislation generated about a 6% average reduction in employer contribution rates (Special Master 75-76), without the Reform Legislation, average employer contribution rates would be about 21-23% of payroll (and that is taking into account the large 24% gain in 2003). Special Master, p. 75. Even if continuing high investment results could further alleviate the shortfall, elementary principles of sound fiduciary management require a system that plans for the worst, even while hoping for the best.

The pressure on employer contributions stemmed largely from the required contributions to amortize the unfunded actuarial liability. This UAL component of employer contribution rates (above the "normal" cost) reflected the $15-17 billion UAL during the 2003 Legislative Session. A $17 billion UAL – with no assurance it would not go higher if investment returns remained under 8% (which happened during much of the 1970's)[24] – seems giant compared to an $11 billion state general fund/lottery budget, and annual local government revenues of approximately $17.8 billion. Special Master, p. 22. In other words, the PERS deficit was equal, in the winter of 2003, to about 2/3 of the annual combined state general fund and local revenues available for all governmental purposes.

C. <u>Conclusion: The System As Operated Prior To The Reform Legislation Was Politically And Financially Unsustainable With Average Pensions Reaching More Than 100% of Salary And Record Deficits And Required Governmental Contribution Rates</u>

The numbers tell the sad story. A series of PERB administrative decisions and interpretations created a financial dynamic that was both: (1) politically unacceptable to the

[24] *The World Almanac and Book of Facts 2004* 125 (William A. McGeveran Jr., et. al. eds., World Almanac Books 2004).

vast majority of the public,[25] and (2) financially unsustainable without diversions of public money from deserving non-Tier One employees (all those hired since 1996), and from vital educational, public safety, and health care services. In a time where many view all governmental bodies with suspicion, PERS became a kind of symbolic Darth Vader given the widespread public perception of systemic abuse.[26]

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[25] Governor Kulongoski's top priority upon election was Reform Legislation of the PERS system; on January 23, 2003, he announced standards by which he would judge plans to reform PERS, and declared that "PERS as we know it is over." On the same day, House Majority Leader Tim Knopp, R-Bend, stated in response, "We are much closer on this issue than most people believe. James Mayer, *State Can't Live With PERS As Is* (Sunrise Ed.) (January 24, 2003) (available in LEXIS, News Library). The Reform Legislation enjoyed widespread bipartisan and public approval throughout, passing with the support of nearly two-thirds of both the House and Senate. *See* Dave Hogan, *House Approves Plan to Overhaul PERS*, The Oregonian (Sunrise Ed.) (May 3, 2003) (available in LEXIS, News Library) (reporting that HB2003 passed by a 38-20 margin). *See also*, Editorial, *As Promised, PERS Reform; Now That Lawmakers Have Done All They Can on PERS, They Must Raise Money For Schools and Other Services*, The Oregonian (Sunrise Ed.) (May 9, 2003) (available in LEXIS, News Library) (reporting that HB2003 passed the Senate by a 19-10 margin).

[26] To illustrate the public's interest in the resolution of the PERS crisis, coverage in *The Oregonian* reached a crescendo in November, 2002 through February, 2003, which saw an average of more than one article per day concerning PERS (32 articles in November, 2002; 34 in December, 2002; 39 in January, 2003; and 40 in February, 2003). Some of these articles reflected the public's great interest in the $15-17 billion UAL facing the state, and its impact on other essential services, such as public education. *See generally e.g.*, James Mayer, *Study Gives Urgency to Legislators' PERS Task*, The Oregonian (Sunrise Ed.) (November 22, 2002) (available in LEXIS, News Library); Ruth Bendl, *PERS Causes Shorter School Year*, The Oregonian (Sunrise Ed.) (November 23, 2002) (available in LEXIS, News Library). Other articles reflected the public's interest in the excesses and windfall-like nature of the PERS system to Tier One retirees, or retirees who "double-dipped" by returning to work, collecting both a pension check and a paycheck. *See generally e.g.*, Dave Hogan, *Payouts by PERS May Swell Even More*, The Oregonian (Sunrise Ed.) (April 9, 2003) (available in LEXIS, News Library); Melissa L. Jones, *More School Workers Collect 2 Checks*, The Oregonian (Sunrise Ed.) (January 30, 2003) (available in LEXIS, News Library). Other articles reflected the public's concern over losing valuable public servants to retirement due to uncertainties of the PERS system. *See generally e.g.*, James Mayer, *PERS Retirements Surge*, The Oregonian (Sunrise Ed.) (January 15, 2003) (available in LEXIS, News Library). Other articles reflected the public's interest in fairness for the PERS pension-holders, who disputed the reformers' characterizations of overly-generous pension payouts, and asserted their right to enforce their pension contract. *See generally e.g.*, Ross Carroll, *Don't Take Away from Retirees*, The Oregonian (Sunrise Ed.) (April 23, 2003) (available in LEXIS, News Library); Kenneth Upton, *Changing Rules for PERS Unfair Now*, The Oregonian (Sunrise Ed.) (April 29, 2003) (available in LEXIS, News Library).

Four factors combined to send the PERS system into severe financial disequilibrium. First, the former PERS Board unreasonably allocated far too much of PERS' high investment earnings during the 1990's to risk free non-variable employee benefit accounts. Second, the surprisingly high account balances created by these overly generous allocations (with gains compounding year to year) could then be DOUBLED *via* the unintended consequences of the "Money Match" option. Third, PERS failed to set a realistic goal for its investment Gain-Loss Reserve, failed to fund the Gain-Loss Reserve even up to its own goal, and failed to fund a statutorily mandated Contingency Reserve. Finally, PERS used outdated mortality tables which yielded higher monthly payments than were justified given actual life expectancies.

This dynamic yielded two unintended consequences: (1) record breaking pension levels *exceeding salaries*, and (2) record deficits and required employer contributions. Benefit levels as measured by "replacement of final salary ratios" – aka "replacement ratios" – grew to the point that the *average* pension in 2002 reached 106% of salary. Special Master, p. 14. For a system with an official "Full-Formula" benefit of 50% of salary, these "in excess of salary" pensions represented an extraordinary windfall to a group of Tier One employees hired before 1996.

The consequence of these extraordinary benefits was a dramatic increase in the money needed from governmental agencies and subdivisions to pay for these "Cadillac" benefits.

Other articles reflected the public concern regarding the reasons for failings of the PERS system, with discussion including imprudent investments as well as the "mathematically flawed" premise of the PERS system itself. *See generally e.g.* James Mayer, *Cap on PERS Account Growth Passes House Unanimously*, The Oregonian (Sunrise Ed.) (January 30, 2003). This intense period of debate and reflection between November, 2002, and February, 2003, demonstrates the high level of public engagement in the PERS Reform Legislation debate, and indicates that an informed public demanded the Reform Legislation supported by nearly two-thirds of their representatives in May, 2003.

Governments and taxpayers in effect assumed the risk of investment losses, while not sharing fully in gains. Reserves – even after an entire decade of stock market boom – were totally inadequate to shelter the system from a storm of investment losses starting in the spring of 2000 and continuing through 2002. The "Cadillac Pensions" – combined with the system's "head in the sand" policy to keep a low or non-existent level of reserves – caused an explosion of the system's unfunded actuarial liability which rose from $1.5 billion to $17 billion during the two years immediately preceding the reform efforts in the legislature. Protection against further "loss" years was non-existent. Any future year with less than 8% earnings would further deepen both PERS' deficit and those of the state, local governments, and Oregon's school districts. The Reform Legislation must be understood in this context.

D. <u>The Legislative Response To The 2003 PERS Crisis Was Carefully Crafted To Preserve All Existing Account Balances and Retiree Payment Levels</u>

Faced in the Winter of 2003 with an unfolding fiscal catastrophe, the Legislature did not indiscriminately hack away at promised benefits. Instead, the Legislature and Governor crafted carefully balanced reforms that preserved all employee account balances and all retiree pension levels without reduction. The growth of future costs and future benefit accruals was, however, restrained. The Reform Legislature attacked the problem through four major devices:

(1) Updated mortality tables,
(2) Diversion of future 6% employee contributions into a Defined Contribution Plan with a symmetrical distribution of risk and loss,
(3) Retooling of the earnings guarantee to mandate appropriate reserves *before* crediting employee accounts, coupled with a clarification of the guarantee as an average, compounded return, and,
(4) Recovery of pension payments, improperly inflated by PERB with imprudent earnings allocations in 1999, out of future cost of living increases.

Petitioners claim that every one of these steps violated their PERS contract with the State. But, as will be shown below, none of the Reform measures violated a promise made by the Legislature intended as immutable even in severe financial distress, and even as to future earnings and accrual of benefits from future service.

IV. NONE OF THE LEGISLATIVE REFORMS VIOLATED OR IMPAIRED STATUTORY CONTRACTUAL PROMISES

The systemic features and financial dynamics in PERS as it operated prior to 2003 did not emanate from statutory promises. Often they did not even arise from non-contractual statutory commands. Rather, the effects outlined above resulted from the administration of the PERS system by its Board and officers under delegated authority. No one needed to act in bad faith for the system to run amuck; the exuberance of the times played a role. But well-intentioned or not, it was most often non-legislative decisions and interpretations that created critical financial instability. And where statutory commands were involved, they were not intended as immutable statutory promises preventing changes as to future service, or were misinterpreted or misapplied.

A. General Legal Principles Used To Construe the PERS Contract: (1) An Intention To Bind Future Legislatures From Amendments With Prospective Effect Must be Clearly And Unambiguously Stated; (2) The PERS Contract Should Be Construed Consistent With All Other Terms And Conditions Of Employment That Modifications Can Be Made For Future Service

Not every statutory command, nor every administrative and fiduciary decision taken pursuant to statutory delegation and duty, creates a binding statutory contract immune from change by future legislatures. *Hughes v. State* 314 Or 1, 28-29, 838 P.2d 1018, 1033-1034 (1992), *Oregon State Police Officers Association v. State* 323 Or 356, 407, 918 P.2d 765, 792 (Gillette, concurring and dissenting, joined by Chief Justice Carson and Justice Graber);

Eckles v. State of Oregon 306 Or 380, 390-391, 397, 760 P.2d 846, 853, 857 (1988). In *Hughes*, a statute exempted PERS benefits from taxation and expressly applied to "all state, county, and municipal taxes heretofore or *hereafter imposed* . . . ." 314 Or at 7 (emphasis added). The Supreme Court held that the tax exemption was contractual as to benefits already "accrued" (earned) through past service, but was not contractual as to new taxes on benefits earned from future service (benefits which "accrue" in the future). 314 Or 27-29.

Where the State is a party to a contract allegedly impaired by subsequent legislation, "a state contract will not be inferred from legislation that does not unambiguously express an intention to create a contract." *Eckles*, 306 Or at 397. Furthermore, although the rule was originally articulated concerning the existence, rather than the extent, of a contract with the State, "the effect of the rule is to eliminate the state's contractual obligation wherever there is doubt concerning the [extent of] the agreement." *Eckles,* 306 Or at 397. (Bracketed words added).

In this case it is the extent, not the existence of, a statutory PERS contract that is at issue. A finding that a particular disputed provision is part of a statutory promise, even as to future earnings and service, limits the power of future legislatures to make amendments necessary for the general welfare. In a democracy, such a limitation on the People's future elected representatives is not to be lightly inferred; there is a presumption – absent clear and unambiguous language to the contrary – that no such limitation on the power of future legislatures is intended. And, as this dispute demonstrates, there is a good reason for this presumption. Government, no less than business, must be able to adjust to changing challenges and circumstances. This is not a story about human malfeasance. It is, rather, a story about systemic failure in a pension system that evolved haphazardly, bit by bit, over the years rather than by any grand design. The "blame" can be spread widely.[27]

The *Hughes* principle allowing prospective changes make great policy sense. Unforeseen and unintended consequences and circumstances inevitably arise in complex human endeavors. Legislators often cannot foresee the affects of statutory words in future and myriad circumstances, or how those words might be interpreted, or how they might be applied under delegated authority. It is less the capacity to foresee future circumstances, and more the capacity to adapt public policy to those new circumstances that makes government work. Both business and governments must be able to transform and modify old ways of thinking and carrying out their activities. It is not our capacity for grand planning that marks our traditions and culture, but rather our adaptive tradition of human ingenuity. We are adaptors more than planners.

One final general consideration, "total compensation," should inform the Court in construing the PERS contract. Pension benefits are part of a compensation package that the employee receives for her work and labor. Indeed, Oregon statutes require arbitrators to consider pensions as but one part of the "overall compensation" to use in making comparisons to other public employers and employees. ORS 243.746(4)(d) and (e). Every other term and condition of employment may be modified prospectively – from future pay rates to future sick leave entitlement to future health insurance and paid holidays and vacations. Why would the Legislature intend a system in which the pension term of total compensation was effectively frozen and immutable – even as to future earnings and service

[27] For example, the provision to give legislators a "Full Formula" that was equal to the higher pensions ratios received by police and firefighters rather than the standard for other public employees demonstrated that the systemic failure reached the legislature as well.

– while virtually all other parts of employees' compensation are modifiable prospectively? No Oregon business could possibly operate under such a restriction and Oregon Legislation fails to "unambiguously express" an intent to freeze future pension benefits.

B. Mandating Updated Mortality Tables Did Not Violate Any Promise Of The Legislature In Establishing The Statutes Pertaining To PERS

Although people on average live four years longer today than they did only 25 years ago, PERS had not, prior to the 2003 Reform Legislature, updated its mortality tables since 1978. The effect was that the monthly annuities calculated on the high individual account balances (after "Matching") were based on a faulty assumption that the monthly payments would be terminated by death, years before the date actually predictable. If the updated tables are used, the account balances or other earned benefits would generate lower monthly payments spread over a longer assumed life after retirement. According to the Special Master, the effect of the new legislatively mandated mortality tables will be to reduce PERS' unfunded liability by $1.6 billion, lowering the required contributions from public employees by an average of 2.09% of payroll costs. Special Master, p. 72. The PERS Board's refusal to mandate updated mortality tables was part of a larger culture that change in the system would be made only if they would provide higher monthly benefit payments to the retirees. With respect to the mortality tables, this "only if better" policy was explicitly adopted as an administrative regulation (OAR 459-005-0055).

Nothing in PERS statutes – as distinct from actions of the former PERS Board and officers – remotely promised the use of outdated mortality tables to ensure that employees would receive higher monthly payments than actually earned in the generous PERS system. First, even without explicit statutory language, it would be a reasonably implied term of the PERS contract that monthly pensions be calculated on the most accurate projection of how long retirees will live. But there is more. ORS 238.605 mandates an actuarial report "every two years . . . . evaluating the current and prospective assets and liabilities of the system and indicating its current and prospective financial condition." ORS 238.605. In developing the actuarial report, the statute specifically directs investigation of the "mortality . . . . experience of the members." *Id.* ORS 238.601, which pre-dated the 2003 Reform Legislation, requires PERB to "administer the system to create and maintain long-term stability and viability in the system" and expressly acknowledges that "PERS depends on the ability of public employers and taxpayers to pay the costs of the system." ORS 238.601.

Judge Lipscomb, of course, found that PERB violated its statutory and fiduciary duties in its practices concerning the mortality tables.[28] While the actuary used updated tables to make projections of future costs in the actuarial report, those updated tables were not utilized in calculating a member's monthly benefit at retirement. Thus, "PERS [in calculating benefits on retirement] generally used AEF's [actuarial equivalent factors] that did not match the assumptions that the actuary used to value the system and make projections about system costs." Special Master, p. 39.

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[28] The unauthorized actions of PERB should not bind the state of Oregon. Federal law clearly provides that the state cannot be estopped by improper or illegal acts of its administrative agency personnel. *See, e.g., Office of Personnel Management v. Richmond,* 496 U.S. 414 (1990) (government not bound by the erroneous oral and written advice given by agency employee to a benefit claimant because equitable estoppel will not lie against government). As articulated by Justice Felix Frankfurter, "[T]he oft-quoted observation...that 'Men must turn square corners when they deal with Government' does not reflect a callous outlook." *Federal Crop Insurance Corp. v. Merrill,* 332 U.S. 380, 385 (1947), citing *Rock Island, Arkansas v. Louisiana R. Co.,* 254 U.S. 141, 143 (1920). While it might be possible under demanding circumstances to estop Oregon agencies, recent cases refuse to permit estoppel against state agencies where the information supplied by the agency is published and in the public domain. *See, e.g., Committee in Opposition v. Oregon,* 309 Or 678, 686, 792 P.2d. 1203, 1207 (1990); *Tidewater Barge Lines, Inc. v. Ore. Environmental Quality Com'n,* 159 Or App 296, 304-05, 974 P.2d. 807, 811-12 (1999), *appeal dismissed,* 330 Or 253 (2000). Because PERS legislation is clearly available to the public, petitioners cannot successfully maintain that illegal and imprudent actions of PERB bind the state.

Prior to the Reform Legislation, ORS 238.630 governed the duties of the PERS Board. Among these enumerated duties is that PERB:

> "Shall 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." ORS 238.630(3)(g).

The actuarial factors referred to legislatively are the factors utilized by the actuary in projecting future obligations, not outdated tables in use for the sole purpose of keeping monthly retirement annuities higher than actuarially justified. Further, far from a statutory promise to the continued use of a particular set of outdated mortality tables, the statute contemplates adjustment "from time to time," so that the calculation of retirement allowances would be based on "actuarial equivalency." *Id.* The PERS Board retained the express power and duty to modify "necessary actuarial factors" to make "optimal forms of retirement allowance" "actuarially equivalent." Judge Lipscomb found that the Board breached its statutory duty in this regard. There was simply no legislative promise to continue using concededly outdated mortality tables to enhance monthly benefits.

Finally, as pointed out in the State of Oregon's Hearing Memorandum (page 17), the "lookback" feature built in to the Reform Legislation [H.B. 2004] greatly softens the effect of the new mortality tables. In essence, newly retiring employees may either have benefits calculated on the accrued balances and older tables in effect just prior to the Reform

Legislation, or they may use the newer tables for all their service, whichever generates a higher pension.[29]

C. The 6% Employee Contribution

Part of the Reform Legislation repealed the mandatory employee contribution into PERS that had existed since 1953. *See former* ORS 237.071, cited in Justice Gillette's opinion in *OSPOA*, 323 Or at 405. That statute provided for a mandatory deduction from the employee's pay: "An active member of the system shall contribute to the [PERS] fund and there shall be withheld from salary of the member six percent of that salary." ORS 238.200(1)(a) (2001). Starting in 1979, under the so-called "employer pick-up" legislation, public employers were allowed by policy or written agreement with their employees or the employees' union, to pay the 6% contribution on behalf of the employees. *Former* ORS 237.075, ORS 238.205 (2001). Often the "employer pick-up" of this mandatory 6% employee contribution came pursuant to collective bargaining agreements in which the "pick-up" was negotiated in lieu of salary increases. *OSPOA,* 323 Or at 373. An initiative measure banning the "pick-up" without any corresponding offsetting benefit to the employees was struck down in a plurality opinion in *OSPOA*. *Id.*

The Reform Legislation repeals the mandatory 6% contribution into PERS member individual accounts, replacing it with an identical 6% contribution into an "Individual Account Plan." These changes apply solely to benefits earned by service after the effective date of the Reform Legislation – i.e., to prospective service only. There are two primary features of this shift: (1) balances in the new "Individual Account Plans" will not be subject

[29] In other words, under the Reform Legislation an employee may retire and use the *old* mortality tables as to benefits earned and accrued by service prior to the effective date of the legislation.

to the "Money Match" (although the Money Match will continue to apply to regular PERS individual employee accounts based on all contributions and accumulated earnings up to the date of the Reform Legislation), and (2) the post-Act accumulations in the new Individual Account Plans carry a symmetrical allocation of the risk of loss and possibility of investment gain. That is, the 6% transferred to the new accounts for service after the Reform Act's effective date will resemble a conventional Defined Contribution Plan, with the employee getting both accumulated gains and losses in the account. The new accounts for receiving and accumulating earnings on the 6% contributions have no effect on benefits earned ("accrued") before the Reform Legislation, or on the "Full Formula" benefit option.

Nothing in the statute formerly mandating 6% employee contributions comes close to a clear and unambiguous statutory promise to allow such employee contributions for the entire life of the employee's service. And unlike the initiative measure struck down by the plurality opinion in the *OSPOA* case, the 2003 Reforms did not forbid "pick-up" payments that often had been negotiated in lieu of higher salaries, but, instead, specifically provided for a continuing 6% contribution (with no effect on employee salaries) into a new defined contribution account.

Neither the original 6% contribution statute, nor the 1979 "pick-up" amendments, utilize any language from which to infer a legislative intent to foreclose future legislatures from modifying the contribution for future service. Certainly such a legislative intent cannot be said to be "clearly and unambiguously" stated. Under the Reform Legislation, the 6% contribution is preserved, but diverted into a separate account with the characteristics of a Defined Contribution Plan that is a symmetrical allocation of both investment risk and gain to the employee.

The pre-Reform statute provides an example of the distinction between a statutory mandate and a statutory promise. The 6% was mandated unless and until changed by a subsequent Legislature. But nothing in the words of the statutes suggests that it would be immutable as to future service at a time when the PERS system faced financial disaster.

D. The "8% Guarantee"

The heading above places the phrase "8% guarantee" in quotes because that term cannot be found in ORS 238.255[30] upon which plaintiffs rely. Instead, the statute provides that the "assumed interest rate" will be credited to the employee's regular account. While the assumed interest rate has been 8%, that assumed rate could change at any time the actuary and Board determines that an 8% average earning projection is no longer appropriate. It is the Board and actuary's discretionary actions, not action of the Legislature, that set a particular rate. The rate may be modified with changing investment return expectations. There was no set rate of return promised as an immutable part of the PERS contract by the Legislature.

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[30] ORS 238.255 (formerly ORS 237.277) provides:

"The regular account for an active or inactive member of the system shall be examined each year. If the regular account is credited with earning for the previous year in an amount less than would have been credited pursuant to the assumed interest rate of that year determined by the Board, the amount of the difference shall be credited to the regular account and charged to a reserve account in the fund established for that purpose. A reserve account so established may not be maintained on a deficit basis for a period of more than 5 years. Earnings in excess of the assumed interest rate for the 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 the deficit. The Public Employees Retirement Board shall attempt to ensure that the reserve account is funded with amounts adequate to leave a zero balance in the account when all members who established membership in the system before 1/1/96, as described in ORS 238.430, have retired."

It can fairly be argued that, while not establishing a specific earnings guarantee, the statute mandates the assumed earnings rate established by the PERS Board. Even that mandate, however, falls far short of an immutable, clear and unambiguous promise that cannot be modified as to future earnings by a future legislature facing a huge deficit in PERS, rapidly rising governmental costs, and lavish pensions expressed as a replacement ratio of salary exceeding 100%. Further, even if ORS 238.255 could be read as a clear and unambiguous legislative promise to continue paying the assumed earnings rate to each employee's account for the work life of the employee, the Reform Legislation expressly provides that no account balance can ever fall below the amount it would have earned with a credit at the assumed interest rate, compounded, each year. Even assuming, *arguendo*, that the legislature intended an immutable earnings guarantee, it is unreasonable to assume the legislative intent was to guarantee *more* than the assumed rate, compounded, for each year.

The wording of ORS 238.255, in fact, suggested that even before the Reform Legislation, the Legislature was well aware of the inevitable problem of fluctuating earnings. The statute mandated a reserve, and prudently directed that "earnings in *excess* of the assumed interest rate . . . *first* be applied to reduce or eliminate . . . a deficit." ORS 238.255 (emphasis added). This is legislation that smacks of a grant of discretion to PERB to determine the amount of necessary reserve accounts and lacks the clarity of an "unambiguous intent" required by *Eckles*.

What the pre-Reform Legislature that adopted ORS 238.255 did not foresee, judging from the statutory language used, is what would happen if lower than assumed earnings persisted for several years. The statute further states that the reserves can run in deficit for only 5 years. It is implied, at least, that earnings may be allocated to the reserve whenever it is in deficit. There is, at least, ambiguity enough to doubt whether an immutable contractual promise to guarantee an 8% return was ever intended at all.

But if a promise was intended, the Reform Legislation's version – a *guaranteed* return at 8% (or other assumed rate), compounded, each year and no more – complies with the intention of any fairly inferred promise. Nothing in the statute even arguably promised earnings *in excess* of the 8% assumed interest rate. The Reform Legislation interrupts the risk free 8% yearly returns in the future, but with two important safeguards: (1) the interruption of 8% lasts only so long as the statutory reserves are in deficit or less than fully funded, and, (2) even when earnings are diverted to replenish reserves, each employee must still be credited with an account balance in these risk free accounts equal to the amount that would have accumulated at 8% a year, compounded. These safeguards satisfy any fairly inferred statutory promise.

Additionally, the Reform Legislation's treatment of the "8% Guarantee" may be supported as a remedial matter. Any PERS contract carried with it the duty of the PERS Board to act prudently and in a fiduciary capacity.[31] Two judges have found or recommended that the Board's earnings allocations during the booming 1990's breached the Board's duty. Insofar as the Reform Legislation merely interrupts the earnings promise while these breaches of fiduciary duty are repaired by rebuilding and maintaining more adequate reserves, there is no breach. Rather, the Legislature sought to restore PERS to the reserved position contemplated in the statute in the first place; so long as each employee maintains an account balance crediting an amount equal to 8% a year, compounded yearly, the Legislative Reform does not work any substantial breach or impairment of the earnings guarantee.

[31] *See* ORS 238.601 (requiring PERB to administer the system "to create and maintain long-term stability and viability in the system").

E. The Interruption Of Retiree Benefit COLA's While Amounts Improperly Credited In 1999 Are Recovered By Set-off Out Of Future Pension Increases

Another key part of the Reform Legislation was to recover some of the amounts improperly credited to retiree accounts in 1999 under Judge Lipscomb's final judgement.[32] Rather than adjust the pensions already being received by recent retirees downward (to the lower amounts they properly should have been at after re-allocations of earnings for 1999 under Judge Lipscomb's order), the Legislature quite generously adopted a "no reduction of present pensions" policy. Instead, the overpayments for the amount improperly credited were to be recouped from future COLA adjustments for retiree pensions. Since the statute already provided for the recovery of overpayments (*see* ORS 238.715), the Legislature's choice to take the money instead from future increases does not violate any contractual promise. PERS retirees take their pension payments subject to the express and clearly set forth statutory condition subsequent that overpayments must be repaid. That is all that the COLA provision does, albeit in a manner more favorable to the retirees. The COLA adjustments merely leave the monthly benefit at the level they would have been at but for the improper allocations of earnings. Effectively, these employees *are* getting their COLA's – they simply received them earlier due to the improper allocations.

F. Summary of Contract Arguments

The *amicus* business groups contend that in construing the PERS contract two general principles apply: (1) the presumption against finding an intent by one Legislature to bind a future Legislature from addressing substantial public welfare issues under the police power (absent "clear and unambiguous" expressions of legislative intent required by *Eckles* to create a binding promise), and (2) that the contract should be logically construed in light of the

[32] HB 2003, § 146(1)(b).

unchallenged fact that every other aspect of total compensation may be prospectively changed as to future service. More specifically, *amici* argue that the Legislature's carefully crafted and balanced PERS Reform did not breach a (1) *statutory promise by the Legislature, (2) intended to be unchangeable* during the entire working life of the employee from the first day of employment.

In the case of the updating of the mortality tables, there was never a statutory command (let alone a promise) to utilize outdated tables in order to inflate the monthly pension entitlement beyond what had been earned in the account balances (and Money Matched); in fact, the Reform Legislature effectuates the original implied promise of reasonably accurate mortality tables, and the express duty to use tables so that various pension options would be "actuarially equivalent."

With regard to the reconfiguration of the 6% contribution prospectively into an account with a symmetrical allocation of investment gains and losses (and not subject to the magical Money Match), no words in either the contribution statute or the "pick-up" statute suggest that the Legislature meant to foreclose amendments, as to future service, by future Legislatures. None of the very fortunate Tier One employees has any reasonable expectation that they would have an unchanging right to pour money into risk free, high return accounts in order to improve their pensions far beyond the official "Full Formula" goal of PERS. There was a statutory promise, but the promise applies to pre-reform contributions and does not extend to prospective contributions for post-reform service. *OSPOA,* 323 Or at 404-412 (Justice Gillette writing for Chief Justice Carson and Justice Graber); *Stranaham v. Fred Meyer*, 331 Or 38 53, 11 P.3d 228, 237 (2000) (*stare decisis* balances the need for stability in law with the "similarly important need for the law to correct past error;" only the Supreme Court can remedy erroneous constitutional doctrine).[33]

Regarding the earnings "guarantee," again, there is arguably no "clear and unambiguous" statutory promise at all, and certainly no "clear and ambiguous" undertaking, in the words of the statute, never to change this risk free guarantee. Second, the statute on its face shows that the Legislature intended that reserves be established that would reasonably protect against investment losses before crediting huge earnings to the employee accounts; the Reform Legislation only interrupts the guarantee while the reserves mandated by the pre-reform PERS contract are restored. Third, the Reform Legislation continues to guarantee an account balance equal to all contributions compounded at 8% a year. Even if the Reform did not merely restore the original Legislative intent regarding reserves, it was never intended to be anything more than an 8% annual compounded return that the Reform Legislation preserves for every Tier One employee.[34]

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[33] The plurality decision in *OSPOA* is distinguishable on other grounds. First, it was an initiative case and not a case arising from carefully deliberated Legislative Reforms in the midst of a fiscal crisis in PERS and a larger state-wide budget crisis. Second, *OSPOA* was a case construing the federal impairment of contracts clause; it did not (despite Justice Fadeley's concurring opinion) address state constitutional law issues. To the extent that *OSPOA* misconstrued federal laws the Supreme Court's duty is to correct that misconstruction, not persist in it.

[34] Again, *OSPOA,* 323 Or 356 (1996) is distinguishable. In *OSPOA* the initiative measure *eliminated* the earnings promise in all circumstances, rather than merely interrupting it while reserves are replenished in accordance with the Legislature's original intent. Second, *OSPOA* did not involve any attempt by the Legislature to clarify that the guarantee was to return at least a gain equal to 8% per year, compounded annually. Yet that is the only sensible construction of the guarantee, a construction not advanced by either party in *OSPOA* or any Justice of the Court. Third, all opinions in *OSPOA* assumed that the initiative measure struck down in that case was retrospective in effect, 323 Or at 412, a position the State does not concede in this case. *Id.* Fourth, inasmuch as the *OSPOA* ruling came under the federal, not state, impairment of contracts clause, the Court's present duty is to apply and construe the federal law in accordance with the precedents established by the U.S. Supreme Court. "[T]he decree of authority belonging to . . . a precedent defends, of necessity, on its agreement with the spirit of the times or the judgement of subsequent tribunals upon its correctness as a statement of the existing or actual law . . . ."

Finally, with regard to the interruption of COLA's for already retired employees with monthly pensions in excess of their proper entitlement due to improperly generous account credits in 1999, the Reform Legislation breaks no promise. The Legislature believed that those that benefitted from the improper allocation to individual accounts in 1999 should "pay back" the excess pensions they were receiving. Pre-2003 legislation permitted the State to recover PERS overpayments. ORS 238.715. But rather than just reducing these pensions down to their appropriate amounts and seeking to have the overpayments returned by the retirees, the 2003 Legislature more generously allowed the excess pensions to remain in effect without reduction, while recouping some or all of the excess payments from future COLA entitlements. Far from violating the COLA promise to retirees, the Reform Legislation implements (by set-off of future increases) the PERS contract and benefits as intended. That is, under the Reform Legislation, every retiree will wind up with no less than the pension she was entitled to plus all COLA increases. Effectively, the retirees subject to the Reform Legislation simply received their COLA adjustment early (in the form of generous earnings allocations they, the retirees, are not entitled to).

The PERS contract should not be construed as a game of constitutional "gotcha." Petitioners' interpretation of the PERS contract, though entirely understandable given the sizable windfall pensions involved, amounts to just that. According to petitioners' simplistic theory, every single mandatory term of the PERS statute is a part of an immutable contract with the State that cannot be adjusted from the first day of employment, even in a budget crisis, and even when reasonable employee expectations in terms of replacement of income ratios are preserved.

Stranahan, 331 Or at 53-54.

In petitioners' view, unlike any other term and condition of employment, the PERS system is a one-way ratchet that can be adjusted only one way – to improve benefits. And to petitioners, the legislatively contemplated reserves and excessive earnings credits are to be ignored; petitioners want the pluses of a PERS contract, but not the reasonable limits that accompany the contract. To petitioners "a deal is a deal" and they deserve the windfall replacement ratios projected (in excess of salary) under the terms of legislative promises that imposed no risk on petitioners and all the risk on the taxpayers and the State. This misinterpretation was never the intent of any promise laid down in clear and unambiguous contact language by the Legislative Assembly.

V. THERE IS NO UNCONSTITUTIONAL IMPAIRMENT OF THE PERS CONTRACT BECAUSE THE LEGISLATIVE REFORMS WERE REASONABLE AND NECESSARY AND SERVED IMPORTANT PUBLIC PURPOSES

United States Supreme Court case law suggests that plaintiffs are mistaken in asserting that the 2003 Legislative Reforms of PERS result in an unconstitutional impairment of obligations of contract in violation of Article 1, Section 10 of the United States Constitution. Whether or not a legislative act results in an unconstitutional impairment of contract is determined pursuant to a three part test set forth over a series of Supreme Court decisions including *Home Building & Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934); *El Paso v. Simmons*, 379 U.S. 497 (1965); *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977); *Allied Structural Steel Company v. Spannaus,* 438 U.S. 234 (1978); and *United States v. Winstar Corporation*, 518 U.S. 839 (1996).

First, there must be "substantial impairment of a contractual relationship." *Spannaus*, 438 U.S. at 244. In *El Paso*, the Court held that "it is not every modification of a contractual promise that impairs the obligation of contract under federal law." *El Paso*, 379

U.S. at 506-07. In *U.S. Trust,* the Court held that there must be a "preliminary . . . determination . . . that . . . [the legislation] has the effect of impairing a contractual obligation." *U.S. Trust*, 431 U.S. at 17. As demonstrated above, the 2003 Legislative Reforms of PERS violate no contractual promises, and in any event certainly fall far short of constituting "substantial impairment."

Second, if there is a substantial impairment it must still be determined whether it is an impairment that violates the Contract Clause which "is not an absolute . . . [prohibition] and is not to be read with liberal exactness like a mathematical formula." *Blaisdell*, 290 U.S. at 428. In *U.S. Trust*, the Court stated expressly that "[t]he Contract Clause is not an absolute bar to subsequent modification of a State's financial obligation." 431 U.S. at 25. "Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." *U.S. Trust*, 431 U.S. at 22. The same point was put differently by Justice Cardozo in *W.B. Worthen C. V. Kavanaugh*, 295 U.S. 56, 60 (1935), where he stated that a contractual obligation cannot be impaired "without moderation or reason or in a spirit of oppression." Certainly the legislature's carefully crafted reforms of PERS cannot be condemned on any of those grounds. Every effort was taken to minimize the impact on individuals and to spread the burdens fairly.

A parallel has often been drawn between Contract Clause jurisprudence and the Fifth Amendment Takings Clause doctrine. In both cases the Court has consistently held that the prohibitions are not absolute. Justice Holmes' famous statement that "Government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law," *Pennsylvania Coal v. Mahon*, 260 U.S. 393, 413 (1922), has equal relevance to the Contract Clause where the Court has consistently articulated the limits of that clause in relation to the police power of the state. "It is the settled law of this court that the interdiction of statutes impairing the obligation of contracts does not prevent the State from exercising such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public. . ." *Manigault v. Springs*, 199 U.S. 473, 480 (1905). Although the Court has appropriately given greater scrutiny to alleged impairments where the state is a party to the affected contract, *U.S. Trust*, 431 U.S. at 23, it has nonetheless given deference to "legislative judgment as to the necessity and reasonableness of a particular measure." *Id.* at 23. In this case the Oregon Legislature has undertaken moderate and reasonable measures to control the escalating PERS funding expenses as a means of assuring that it can meet the whole range of its obligations under the police power.

Finally, an otherwise permissible impairment of contractual obligations may be held unconstitutional if there is some less burdensome means available to the legislature to achieve a legitimate public purpose. "[A] state is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well." *Id.* at 31. It is not evident that the Legislature could have achieved its clearly legitimate objective of controlling the ballooning costs of PERS by less burdensome means. Indeed, the 2003 PERS reforms successfully controlled costs while leaving PERS beneficiaries with pension benefits comparable to or better than most private employees and without breaching any promises made by the Legislature.

Taken as a whole, this three part test, like most of the Supreme Court's individual rights jurisprudence, requires the courts to balance the competing constitutional values of individual and public liberty. As the Supreme Court stated in *Spannaus*, "[t]he severity of the impairment measures the height of the hurdle the state legislation must clear." 438 U.S. at 245. In this case, the PERS beneficiaries lose only what are windfall gains from unauthorized PERB actions, while the State is better able to provide for the education, health and welfare of the people of Oregon. At least since its decision in *Blaisdell*, the Court has recognized that the Contract Clause does not deny to a State the "authority to safeguard the vital interests of its people." 290 U.S. at 435. That is precisely what the Oregon Legislature has done with its 2003 PERS reforms.

The U.S. Supreme Court's most recent decision on the Contract Clause focused largely on two closely related defenses available to governments where an impairment of contractual obligations is found. In *United States v. Winstar Corporation*, 518 U.S. 839 (1996), the Court, without a majority opinion, addressed the unmistakability and sovereign acts doctrines, both of which are concerned with the extent to which the State can contract to limit future legislative sovereignty. The unmistakability doctrine holds that a state may not contract away an essential attribute of sovereignty, unless it does so unmistakably. *Id.* at 887-88. The sovereign acts doctrine provides that "[what]ever acts the government may do, be they legislative or executive, so long as they be public and general, cannot be deemed specially to alter, modify, obstruct, or violate the particular contracts in which it enters with private persons." *Winstar*, at 892 (quoting *Horowitz v. United States*, 267 U.S. 458, 461 (1925) (quoting *Jones v. United States,* 1 Ct.Cl. 383, 384 (1865))). While neither doctrine provides a clear defense for the state in this case, both rely on a distinction having direct relevance to the validity of the 2003 PERS reforms.

Both doctrines depend on distinguishing between sovereign acts of the state and state actions that are analogous to private actions. As a general rule, the courts have sought to treat the state as they would a private party in the interpretation of contracts to which the state is a party. *Winstar*, 518 U.S. at 892-893. In applying the Contract Clause, the courts have been wary of impairments of obligation where the state stands to benefit. *Winstar*, 518 U.S. at 895-896. But that is not the case with the 2003 PERS Reform Legislation. Although the State stands to save PERS funding expenses, it does so with the recognition that these expenses were incurred due to the clearly unauthorized actions of PERB in employing out-of-date mortality tables and failing to adequately fund the gain-loss and contingency reserve funds the Legislature established.[35] The State seeks merely to restore its authorized level of financial commitment.

If there has been any unilateral, self-interested modification of the contractual obligations inherent in PERS, it has come at the hands of PERB which operated under the express policy of only taking actions that improved the pension benefits provided by PERS. The facts of *El Paso* are directly relevant to this point. In that case, "a 19th century statute had effects that were unforeseen and unintended by the legislature when originally adopted. As a result speculators were placed in a position to obtain windfall benefits. The Court held that adoption of a statute of limitation was a reasonable means to 'restrict a party to those gains reasonably to be expected from the contract' when it was adopted." *U.S. Trust*, 431 U.S. at 31 (quoting *El Paso*, 379 U.S. at 515-516). The 2003 PERS Reform Legislation is a reasonable means to restrict PERS beneficiaries to what they could reasonably expect from the original contract with the State.

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[35] In finding against the government in *Winstar*, the Court expressly found that the government "had ample statutory authority" to make the promises in question. 518 U.S. at 890.

The central challenge in Contract Clause jurisprudence has been "harmonizing the constitutional prohibition with the necessary residuum of state power." *U.S. Trust*, 431 U.S. at 15. As evidenced by the Court's multiple opinions in *Winstar* and its ability to clearly define the scope of state sovereign acts in the context of its 10th Amendment jurisprudence, *see* Laurence H. Tribe, *American Constitutional Law* 860-903 (3rd ed., West 2000), there is no clear line to be drawn between the state actions under the police power and actions that are fairly analogized to private conduct. Most would agree that the power to tax is clearly sovereign and the power to enter into a procurement contract is clearly not sovereign. But where the State faces enormous financial obligations that have arisen through the unauthorized actions of an administrative board, the distinction between taxation and a reduction in those financial obligations is unclear at best. In both cases, the State can be fairly said to be acting in the public interest and not for the purpose of "self relief."

Where a contract allegedly restricts the police power of future Legislatures – i.e. the People's own ability in a democracy to control their government *via* their elected representatives – the contractual duty is not absolute. As recognized in the *OSPOA* case (decided under federal law), even where there is a substantial impairment of a legislative promise, there is no violation of the Constitution where:

> "[T]he state law creating the substantial impairment is justified by a significant and legitimate public purpose and . . . the method used by the state to advance the public purpose [does not] constitute an unnecessarily broad *repudiation of its* contractual obligation . . . ." [Bracketed words added.] *OSPOA*, 323 Or at 364-365

In this case, Governor Kulongoski and the 2003 Legislative Assembly faced an initial shortfall for the state budget of just under $2 *billion* dollars. Increases in required PERS contribution rates to amortize a rapidly growing unfunded actuarial liability added hundreds of millions to this deficit. At the same time stories about bigger than salary pensions, and replacement ratios far in excess of the "Full Formula" benefit filled the press.[36] And, as the Legislative Assembly deliberated, the PERS UAL was projected in the winter of 2003 to have reached $17 billion (from only $1.5 billion two years earlier). Projected contribution rates going forward were expected to reach 25% of payroll and remain there for years to come. The only sources of revenue were further cuts in public services like education, corrections, and health services, or further wages freezes and other "rollbacks" for other public employees.

At the same time, PERS' structural problems – as it was operated prior to 2003 – had become transparent. As PERS was being administered, any year in which investment returns did not reach 8% would further deepen the unfunded liability. And the last year before the Legislative Session (2002) had yielded negative results of -8.2 %, effectively 16.2 % less than that required for a "hold even" posture. Special Master, p. 32. No one knew that PERS would wind up with a 24% gain in 2003, just as no one can now predict what the final gain or loss will be in 2004, or 2005, or 2006. *Id.* To have merely crossed legislative fingers and hoped for the best would have been irresponsible and imprudent. And government's ability to demonstrate to disaffected taxpayers and voters that it can set its own house in order would have been destroyed.

To see the reasonableness and necessity of the changes made in a bipartisan legislative effort, the Court need only consider the consequences of holding the Reform

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[36] *See, generally,* e.g., David Reinhard, *We've Earned PERS Bonanza, Mister*, The Oregonian (Sunrise Edition) (January 26, 2003) (available in LEXIS, News Library); Tim Knopp, *In My Opinion Legislature Must Achieve PERS Reform*, The Oregonian (January 30, 2003) (available in LEXIS, News Library); Editorial, *Cutting PERS Down to* Size, The Oregonian (February 16, 2003) (available in LEXIS, News Library).

Legislation unconstitutional. The replacement ratios for most "Tier One" retiring employees will again rise above 100% of salary, with the attendant pubic outrage that inevitably follows. Required contribution rates from cash-strapped governmental bodies will (even counting the extraordinary, if unanticipated, gain in 2003) again rise to an average of above 20% of payroll, deepening budget holes by hundreds of millions of dollars for many years to come. And in the larger picture, public confidence in government will be further undermined.

VI. CONCLUSION

The 2003 Legislative Reforms of PERS did not breach any term of the PERS contract, properly construed. Where a breach might be otherwise arguable – as with the retiree COLA's – there is no breach because the Legislature simply sought to recover past excessive payments out of future increases in a "set-off" arrangement, or to temporarily interrupt a guaranteed payment while reserves are replenished as always contemplated in the PERS contract. Without an impairment or violation of an applicable promise, there can be no constitutional violation and the Reform Legislation passes constitutional muster.

The stakes in this case are high. Billions of dollars are involved, for taxpayers and PERS beneficiaries alike. Governor Kulongoski and the bipartisan leadership that supported the Reform Legislation – often against furious lobbying efforts by public employees who had been political supporters – stepped up to a major challenge for our system of government. Now the Supreme Court must decide whether the 2003 Legislature's hands were tied as contended by petitioners. Oregon's business and jobs climate hangs in the balance. A state unable to control governmental pension costs, to reasonable, but still generous levels, provides a less stable and attractive investment climate.

Respectfully Submitted,

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