IN THE SUPREME COURT OF THE STATE OF OREGON

In the Matter of the Consolidated Public Employees Retirement System (PERS) Litigation	) Case Names and Numbers:	
	Strunk	X (S50593) (Control)
	Burt	_____ (S50647)
	Dahlin	_____ (S50645)
	Evans	_____ (S50532)
	Petrillo	_____ (S50687)
	Sartain	_____ (S50686)
	Whitty	_____ (S50685)

STRUNK PETITIONERS' OPENING BRIEF

Petition for Direct Judicial Review of HB 2003, HB 2004, and HB 3020

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INDEX OF CONTENTS

APPENDIX (published with Excerpt of Record as a separate document)

INDEX OF AUTHORITIES

Cases

Constitution, Statutes and Rules

Other Authorities

APPELLANT'S OPENING BRIEF

I. STATEMENT OF THE CASE

A. Nature of the Action

This is a petition for judicial review of certain sections of Chapters 67 and 68,[1] as amended by Chapter 625,[2] of the Oregon Laws 2003, that substantially altered the Oregon Public Employees Retirement System (PERS). The Strunk petitioners are among several current and retired Tier One PERS members whose benefits have been, or will be, reduced as a result of the operation of the challenged sections.[3]

In this consolidated litigation, petitioners contend that the challenged sections constitute, in the alternative: (1) an unconstitutional impairment of their PERS contract in violation of Article I, Section 21, of the Oregon Constitution; (2) a breach of that contract in violation of state law governing pensions; (3) an unconstitutional taking of their property interest in their PERS contract without just compensation in violation of Article I, Section 18, of the Oregon Constitution; and/or (4) a breach of the settlement of the *Chess* case settlement agreement (*Chess et al. v. State of Oregon et al.*, Marion County Circuit Court No. 93C-11180). To remedy these alleged violations, petitioners have requested both declaratory and injunctive relief as applied to their PERS contracts.

B. Nature of Judgment Sought to be Reviewed.

There is no judgment as this constitutes a direct judicial review of a legislative enactment.

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[1]House Bills 2003 and 2004, respectively (hereafter "HB 2003" and "HB 2004").

[2]House Bill 3020 (hereafter "HB 3020").

[3]The specific sections challenged are: Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004, as amended by HB 3020.

C. Statutory Basis of Jurisdiction.

The challenged legislation expressly confers jurisdiction upon this court to determine whether the provisions breach any contract between members of the Public Employees Retirement System and their employers or violate any constitutional provision. Or Laws 2003, ch 67, §37, ch 68, §5, as amended by ch 625, §§17 and 17a.

D. Timeliness of Petition for Judicial Review.

HB 2004 became effective on May 9, 2003 and HB 2003 on July 1, 2003. The Strunk petitioners filed their petition on July 22, 2003. The petition is timely because it was filed within 60 days of the effective date of HB 2003 and by August 15, 2003, as required Or Laws 2003, ch 67, §37 and ch 68, §5, as amended by ch 625, §§17 and 17a.

E. Questions Presented on Appeal.

1. Whether Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 impair petitioners' PERS contracts in violation of Article 1, Section 21 of the Oregon Constitution.

2. Whether Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 breach petitioners' PERS contracts.

3. Whether Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 constitute a taking without just compensation of petitioners' property interest in violation of Article 1, Section 18 of the Oregon Constitution.

4. Whether Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(b)&(2) of HB 2003 breach the terms of the *Chess* settlement agreement.

5. Whether the Special Master erred in not compelling production of attorney general opinions, withheld under a claim of attorney/client privilege, relating to Trust Administration.

F. Concise Summary of the Argument.

Although petitioners have raised four alternative legal theories in their petition to this court, all their claims are premised upon a few simple principles of well-established Oregon law. Those principles are that: (1) the PERS pension plan is an offer of a unilateral contract for benefits which can be accepted by the tender of part performance by the employee; (2) following acceptance by tender of part performance, an employee's contractual interest in PERS benefits may not be substantially impaired or taken without just compensation by subsequent legislation; and (3) the contractual interest in PERS benefits protected from subsequent substantial impairment or taking includes benefits attributable to both past and future service so long as there is no specific statutory language excluding such benefits from the general contractual promise.

The challenged sections of HB 2003 and HB 2004 amend long-standing provisions of the PERS Act which are essential to the calculation of the retirement benefits promised to petitioners. The provisions amended use absolute and mandatory language and contain no reservation of right of future amendment by the state. The 2003 amendments to these provisions were passed for the express purpose of reducing employer contribution rates and achieve that purpose through an elimination of approximately 8 to 10 billion dollars in benefits promised to PERS members, including petitioners.

This substantial reduction in PERS benefits promised to petitioners is effected through a combination of provisions impacting the value of petitioners PERS accounts:

- diversion of their 6 percent contributions from their regular member accounts;
- elimination of the 8 percent guarantee of annual earnings to their accounts;
- elimination of "the Call" protection for funding of the 8 percent guarantee to their accounts;
- change in the method of crediting earnings to their accounts;
- elimination of their right to invest in the variable account;
- elimination of cost of living increases for alleged over-crediting of members accounts;
- change in the definition of administrative expenses deductible from earnings credited to their accounts; and
- reduction of the actuarial equivalency factors applied to convert their account balances into a monthly benefit.

Under Oregon law, none of the justifications relied upon by the legislature when enacting the 2003 legislation, or raised later as affirmative defenses by respondents, can justify the substantial impairment, breach, and/or taking of petitioners' contractual and property interests in the PERS benefits promised to them.

G. Summary of the Facts.

The facts about Strunk petitioners are, for the most part, not in dispute. The Special Master made specific findings regarding each petitioner, which are set forth at JER-92-98. The Strunk petitioners rely upon those specific findings as well as most of the more general findings made by the Special Master regarding the history and operation of PERS and the challenged legislation. To the extent petitioners disagree with any of those general findings, they raise those disagreements as part of their argument. Additionally, petitioners provide the following supplement to those findings:

1. Introduction

To a substantial degree the 2003 legislation being challenged in this case focuses on individual employee accounts in PERS, either eliminating contributions to those accounts, modifying the earnings received by those accounts, or alternatively, amending the way those accounts are converted into a final monthly retirement benefit. In addition, a number of justifications advanced for this legislation, relate to the handling of those individual employee accounts or the relationship between those accounts and certain reserve accounts within the fund. For that reason, some review of the historic role of individual employee accounts within the PERS system is appropriate.

2. PERS at inception

At the outset, in 1945, the legislature expressed its goal of providing a retirement allowance for full career employees of one-half of their final salary for service after July 1, 1946. OCLA § 90-714. However, rather than adopting a formula plan which would have provided a pension of 50 percent of final average salary based on a full career, the legislature took a very different approach. It provided that members would have individual accounts and make contributions to the plan in an amount actuarially calculated to be sufficient, with earnings, to provide one-half of the proposed retirement benefit. OCLA § 90-714. At retirement, a PERS participant would receive an annuity based on the value of their account matched by a similar annuity provided by the employer.[4] OCLA § 90-719. This combination of annuities would hopefully reach the 50 percent goal established for the system. In addition, retirees would receive a prior service pension of $4 per year of service

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[4]This retirement benefit calculation method has come to be known as "Money Match" (JER-225) and remains one of the three alternative benefit calculation formulas of the system. *See* ORS 238.300.

based on service prior to 1946 which was funded solely be employer contributions. OCLA § 90-715. The statute specifically provided for the establishment of employee accounts which would show "the amount of the member's contributions to the fund, the interest which they have earned, and the deductions from them for administrative expenses of the system." OCLA § 90-710(2).[5] Thus, the legislature clearly provided that employee accounts were to receive the benefit of the earnings on those accounts, which was, of course, the only hope that members would have of achieving an annuity which approached the goals of the system.

The reason for the legislative adoption of this unusual approach is clear. In the design of any pension system which is to be pre-funded by employer or employee contributions, or both, it is crucial to determine who will bear the risks and rewards of market returns on those pension plan investments. If the 1945 legislature had adopted a typical formula plan to achieve its 50 percent goal, then the risks of market performance would have fallen solely on the employers. Conversely, the plan as actually designed placed the risk of market performance solely on employees.[6] By adopting this approach, the legislature made certain that if the investments of the fund did not match the actuary's 2 1/4 percent earnings assumption (JER-122), then the result would simply be lower pensions for PERS participants without any potential increase in liability to employers. The only risk taken by employers in the initial design of the PERS plan was payment of the past service credit and assuring payment of the annuity to a PERS retiree once that annuity had been granted.

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[5]Though administrative expenses are now paid out of the total earnings of the fund, the language providing for the establishment of employee accounts and the requirement that they receive the contributions and the interest earned on those contributions has remained virtually unchanged to this date. ORS 238.250.

[6]Employees also had the potential that higher earnings would produce a higher pension benefit, though the conservative nature of the fund's investment at that time made such an upside purely theoretical.

3. Creation of Reserves

Though there were no changes in the benefit structure of the PERS system for the first 22 years of its existence, both the PERS board and the legislature developed reserves and reserving requirements which had an impact on the fund. At the PERS Board's March 4, 1947 meeting (JER-123), the board created a new reserve to facilitate payment of benefits to retirees. At retirement, the employee's account was to be transferred to this fund along with a transfer from the employer's account sufficient to fully fund that employee's pension (including the past service component). This fund is known currently as the benefits-in-force reserve (BIF).[7] Not only was the creation of this reserve administratively convenient but also, it added stability to the fund, because by pooling the retirement obligations of all employers this now-larger group could be reasonably expected to more closely match the assumptions used by the actuary in calculating benefits. JER-123.

Though the creation of the BIF brought some stability to the system, it did not aid in the liquidity problems that the PERS board faced. In the latter part of 1948, the board approved language to be submitted to the upcoming legislature to create what is commonly called the contingency reserve. JER-124-125.[8] The 1949 legislature adopted PERS' proposed language to create the contingency reserve. Or Laws 1949, ch 586, § 1. The statute required funding of the contingency reserve, though permitted the board at its discretion to direct up to 5 percent of the earnings of the fund in any year to this reserve. The purpose of

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[7]This account has been referred to by a number of names over the years. Originally it was referred to as the reserves for pension and annuities. For simplicity's sake it will be referred to by its current description as the benefits-in-force reserve (BIF).

[8]At the same meeting that the board initially expressed concern about the liquidity of the BIF it also approved its annual financial statement showing that of the approximately $5.5 million that the PERS system had in assets at that time only $33,651.08 had been transferred to this newly-created BIF. *Id.*

the reserve was to "prevent any deficit of monies available for the payment of retirement allowances due to interest fluctuations, changes in mortality rate, losses of invested capital or other unforeseen contingency." *Id.* Examining this statutory language in light of the financial condition of PERS, at that time, makes it clear that the concern being addressed by the statute was that there would be insufficient money in the retiree reserve to pay for benefits when due. The statute itself refers to a "deficit of monies" as well as potential fluctuations in mortality and earning rate, both of which are critical in assuring the adequacy of the BIF. The context of the enactment of the contingent reserve statute suggests quite strongly that the concern of the PERS board was that they would not have the money to pay the bills at the time they became due.[9]

In 1951, the legislature took an additional significant step to protect the liquidity of the BIF by giving it a preference in the distribution of the income of the PERS fund. The language of the statute is awkward, but a careful reading shows that the intention of the legislature was to create an earnings preference to protect the BIF. The statute required an initial distribution of 2 1/4 percent[10] to the BIF and then provides that if total income is in excess of 2 1/4 percent, then the BIF shall participate in such excess. Or Laws 1951, ch 323, § 1. In other words, if total fund income is less than 2 1/4 percent, then the BIF will receive a preferential distribution of the full 2 1/4 percent with the remainder distributed pro-rata to the employer and employee reserve accounts. Conversely, if total income is in excess of

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[9]This concern for liquidity must be understood in the context of the PERS benefits structure. While at that time only minimal benefits would have been earned on the current service portion of the plan, participants were given up to 20 years of past service credit (OCLA §90-715) for which there was no funding. As late as 1952, the PERS board noted that many employers had overdrafts in their past service accounts. JER-127.

[10]This was the then-existing PERS actuarial assumption. JER-122.

2 1/4 percent, then it is shared pro-rata throughout the system. This would serve the legislative purpose of making certain that sufficient monies were distributed to the BIF to meet actuarial expectations while at the same time allowing excess funds to be distributed pro-rata throughout the system. The need for such a preference can be seen by reviewing PERS earnings up to that time which were substantially below expectations.[11] Actual distribution of the earnings of the fund by PERS for the years following the enactment of the statute was consistent with this reading of the statute.[12]

Both the creation of the contingency reserve and the establishment of the preference for the BIF aided employers in making certain that funds would be available to pay the promised benefits without an upward adjustment of employer contribution rates.[13] Conversely, to the extent that these reserves diverted some of the earnings on employee accounts to other purposes, it made it that much more unlikely that the employee accounts would reach the goals of the system. It is not surprising, therefore, that by 1967, when the legislature made the first significant amendment to the PERS benefits structure that, the

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[11]Earnings for 1949-50 were 1.88% and for 1950-51 were 1.97%. JER-170.

[12]In 1967, the statute was amended to increase this preferential distribution to 3.25 percent for post-January 1, 1968 retirees (Or Laws 1967, ch 622, § 22) to be consistent with the PERS interest assumption of 3.25percent. JER-143. In 1973 the statute was once again amended to authorize the PERS board to make a preferential distribution consistent with the board's actuarial earnings assumption. Or Laws 1973, ch 704, § 13.

[13]Although the legislature took action to protect the BIF, it also confirmed that the employers bore the ultimate responsibility for funding the BIF. Oregon Laws 1951, ch 323, provided that actuarial deficiencies in the BIF would be cured by transfers from the employer reserves. This process has become known as truing-up the BIF. JER-19.

legislative history shows that the original benefit structure of the system completely failed to reach the legislative goals for that system.[14]

4. 1967 Reforms

a. Creation of Pension Plus Annuity.

The benefit structure of PERS remained unchanged until the 1967 legislature made several significant changes, including the creation of a new retirement benefit which became known as pension plus annuity. In lieu of the matching employer annuity which had existed since the inception of the system, pension plus annuity substituted a defined benefit pension based on years of service within the system and final average salary as the employer-provided pension. Or Laws 1967, ch 622. Employees would now receive an employer-funded pension based on their final average salary times their years of service times 0.67 percent of salary, thus after 30 years an employee would receive a pension benefit of 20 percent of their final average salary.[15] Though this newly established employer pension was less than the stated goal of the prior system, it was, nonetheless, considered an improvement because of the woeful inadequacy of the prior system.[16] JER-128. Employees continued to

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[14]Joint Ways and Means Committee, HB 1264, 1967, Ex. 21 (Employes with No Prior Service). JER-130-133.

[15]This formula was increased in 1971 (Or Laws 1971, ch 738, §2 (HB 1397)); and again, in 1973, to its current level of final average salary times years of service times 1.0 percent for general service employees and 1.35 percent for legislators, police officers, and firefighters. *See* Or Laws 1973, ch 695, §4 (SB 411).

[16]Though the perception was that the pension plus annuity benefit would be greater than the old money match benefit; nonetheless, in the year following the enactment of the pension plus annuity benefit the PERS board discovered that some participants would have received a greater benefit under the old system. JER-142. The 1969 legislature addressed this problem by re-inserting the old money match benefit back into the system as a minimum benefit. Or Laws 1969, ch 650, § 7. This alternative minimum money match benefit continues as part of the system to this date.

receive the employee annuity as previously provided, though the legislature did fix employee contribution based on salary level (Or Laws 1967, ch 622, § 4) rather than the old system which adjusted those contribution amounts based on the employee's age at entry into the system.

b. Investment in Equities and Creation of the Variable Account.

The second, far more significant, change in the system was a decision by the legislature to permit the PERS system to begin investing in the equities market. Or Laws 1967, ch 335, § 7. Though the legislature initially limited investments in equities to 10 percent of the assets of the fund,[17] it is clear that the legislature understood the power of the equities market to deliver returns in excess of those historically enjoyed by the system. JER-129-133. At the same time that the legislature permitted investment in the equity market, it also established a variable account program which allowed PERS participants to direct a portion of their own accounts directly into a stock equity fund. Or Laws 1967, ch 622, § 24. The legislature anticipated that equity market returns would enhance the value of the employee variable accounts as they specifically stated in the preamble to the establishment of the variable account that they anticipated that earnings on those accounts would likely outstrip the earnings on the regular account. Or Laws 1967, ch 622, § 24.

Thus, by the time these legislative reforms were complete, there had been a significant change in the allocation of the risk and rewards of investment earnings within the system. For the first time, through the establishment of the pension portion of pension plus annuity, employers promised a benefit which would not change based on market returns.

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[17]This amount permitted has been increased over the years to 50 percent. ORS 293.726.

While the employees continued to bear the risk of low market performance in the valuation of their own accounts, for the first time, employers took on some risk as they were solely responsible for funding the pension portion of the pension plus annuity benefit. Perhaps much more significantly, the introduction of market equity investments made the possibility of higher-than-anticipated market returns a possibility. In the event of higher returns, the employee annuity would be enhanced while at the same time the cost of the employer-provided pension would be diminished as would the ultimate cost of providing the benefits provided through the BIF.

5. The Guarantee

In 1973, PERS suffered its first year of adverse returns in the equities market, resulting in a zero distribution to employee accounts. Discussions took place at the PERS board about methods of evening-out the distribution to employee accounts (JER-144-149) which, ultimately, led to the passage, by the 1975 legislature, of what has often been referred to as the PERS guarantee (Or Laws 1975, ch 333). The statute provided in essence that PERS accounts would be credited with no less than the system's long-term actuarial assumption in any year. While this provision clearly insulated employee accounts from suffering in years of bad investment performance, it had an additional, less obvious, impact. The legislature clearly understood that establishing a guarantee had some financial risk to employers, so it took steps to limit that exposure. Recognizing that the PERS board already had the authority to fund a reserve from employee earnings to provide a source of payment in years of poor investment return, (Or Laws 1967, ch 622, §21a),[18] the legislature provided

[18]This reserve became known as the gain/loss reserve. To the extent that employee earnings were diverted to this reserve account, the statute would also have the impact of

(continued...)

additionally that, if necessary, this guarantee could be paid from a deficit account and assigned the responsibility to repay the deficit to future employee earnings. Or Laws 1975, ch 333, §2. Only if the deficit remained for five years, would employers assume responsibility.[19] As will be discussed more fully below, the creation of this guarantee and its attendant reserve has, in fact, on balance had the impact of moderating the growth of accounts while at the same time bringing additional stability to the PERS system. JER-162-163; Tr. Vol. 1 155, JER-163-165.

6. Full-Formula

The final major change in the PERS benefit structure took place in 1981 with the adoption of the full formula pension. Or Laws 1981, ch 786, § 4. The legislature replaced the pension plus annuity system with a new formula based solely on a member's final average salary and years of service in the system.[20] The legislature left undisturbed the traditional money match benefit as an alternative if it would provide a benefit in excess of that provided by full formula.

Thus, by the early 1980s, the legislature had created a pension system of unusual complexity providing, for many members, three alternative methods of calculating a pension benefit. JER-225. In addition, the system allocated the risks and rewards of market performance in a much more complex fashion than under plans of a much simpler design. In a traditional defined benefit pension plan, which provides a pension unrelated to an employee

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[18](...continued)
moderating distributions to employee accounts in years of good investment performance.

[19]This provision came to be known as "the Call."

[20]In order to protect individual members' contract rights the legislature retained the pension plus annuity benefit as an alternative for those members who had service in the system prior to the institution of the full formula benefit.

account, the employer enjoys the full benefit of good market returns and suffers the full impact of adverse market returns, both of which impact employer contribution rates. In the PERS system, good market returns provide benefits for both employers and employees. Employees are benefitted by increases in their individual accounts, though those increases are moderated by the ongoing funding requirements of the gain/loss reserve. Good returns provide a benefit to employers by lowering their obligation to fund the BIF for retirees as well as receiving higher returns on their accounts in the PERS system. JER-48. Conversely, poor market returns will have an adverse affect on employers because their responsibility to fund the BIF for retirees will become more expensive and they will have lower earnings on their accounts. The impact on employees is again more complex than is typical. Employees are potentially sheltered from bad returns because of the guarantee, though to the extent that is pre-funded by employee contributions to the gain/loss reserve that guarantee simply evens out the growth of their accounts. If the gain loss reserve is inadequate to fund the guarantee, then a deficit is created which is retired by future employer earnings. *See* ORS 238.255. Only if there is a Call, do employers have a responsibility to fund this deficit. *Id.* There has never been an employer call under this statute. Tr. Vol. 1 137.

7. Post-Full Formula System

After the creation of the full formula benefit, the PERS benefit structure remained unchanged until the 1995 legislature amended the benefit formula for those who joined the system after January 1, 1996. These members, who became known as Tier Two members, did not have a guarantee on their employee accounts, had a later retirement age, and some limits were placed on the calculation of their final average salary for purposes of the full

formula benefit. Or Laws 1955, ch 654, § 2.[21] Finally, in 1997 the legislature created the Public Employee Benefit Equalization fund to provide a vehicle for payment to PERS members whose benefits exceeded their final average salary as well as the limits provided by Internal Revenue Code § 415. *See* Or Laws 1997, ch 201.

Although the 1981 legislature may have believed that, at some point, full formula would become the dominant form of pension benefit in the system, good market returns on employee accounts continued to enhance the value of both pension plus annuity and money match, preventing full formula from ever reaching a dominant position. Indeed, by 1990, only about 20 percent of retirees retired on full formula, with the remainder of retirees split between money match and pension plus annuity. JER-226. By the time of the 1997 actuarial valuation, good market returns had pushed the value of money match beyond that of pension plus annuity so that it became the dominant retirement methodology for Tier One participants. Tr. Vol 1 189; JER-161.

Despite the fact that benefits during the 1980s and 1990s for PERS participants were increasing, employer rates generally trended downward, while at the same time the fund, for the first time in its existence, approached full funding with no unfunded actuarial liability. A review of historic employer contribution rates shows that in the late 1970s rates generally hovered in an area near or above 11 percent while by the 1990s those rates had fallen into single digits. JER-240. At that same time, the PERS fund went from being 59 percent funded in 1975 to 100 percent funded by 1989 and hovered in the 90 percent funded range for

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[21]Once again, this change impacted the risks and rewards of market performance within the system. Clearly Tier Two members now were exposed to the impact of bad market performance but they also enjoyed the full benefit of good market performance as they did not participate in the gain/loss reserve.

the entire decade of the 1990s. JER-239. Indeed while the passage of HB 3349 placed a $1.3 billion burden on the fund and increased employer rates by 1.4 percent (JER-41), just two years later, by 1999, the fund was back to a 98 percent funding ratio (JER-239) and at the same time employer rates had once again resumed their downward trend.

In 2000, 2001, and 2002, the PERS system suffered its longest period of adverse market returns in the 30-plus years that the system has participated in the equity markets. This experience was by no means unique to Oregon PERS but rather, had an impact on pension investments, both public, private, corporate and individual, all over the country. Tr. Vol1 204-207. As a result of this adverse market performance, employer contribution rates were set to rise, and rise substantially, before the impact of the 2003 legislation. JER-171. It was this increase in employer contribution rates which led directly to the actions of the 2003 legislature, undertaken specifically for the purpose of reducing those rates.

II. FIRST ASSIGNMENT OF ERROR

> **First Assignment of Error:** Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 impair petitioners' PERS contracts in violation of Article I, Section 21, of the Oregon Constitution, and/or breach those contracts such that they are entitled to a remedy.

A. Preservation of Error

In their petition to this court, the Strunk petitioners alleged that Sections 1, 3, 5,6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 violated Article I, Section 21, of the Oregon Constitution, and/or breached their PERS contracts. Those allegations can be found in paragraphs 21, 27, 38, 43, 51, 56, 65, 70, 79, 84, 92, 94, 1O0, 105, 111, 116, 124, 129, 138, and 143 of their petition. JER-182-223.

B. Standard of Review.

As explained above, Oregon Laws 2003, ch 67, §37, ch 68, §5, as amended by ch 625, §§17 and 17a, expressly confer jurisdiction upon this court to determine, *inter alia*, whether the provisions "breach any contract between members of the Public Employees Retirement System and their employers or violate any constitutional provision, including but not limited to impairment of contract rights of members of the Public Employees Retirement System under section 21, Article I of the Oregon Constitution * * *." Although, the legislation authorized this court to appoint a special master in the event it determined there were factual issues in the petition, the special master was only "to hear evidence and prepare *recommended* findings of fact." *Id.* §17(6) and §17a(6) (emphasis added). Therefore, the standard of review is *de novo*.

C. Argument.

1. <u>Article I, Section 21, of the Oregon Constitution Prohibits Legislative Impairment of the State's Contract Obligations.</u>

Article I, Section 21, of the Oregon Constitution, adopted in 1859, provides in relevant part: "No law * * * impairing the obligations of contracts shall ever be passed." The provision is applicable to both state and private contracts. *Eckles v. State of Oregon*, 306 Or 380, 390, 760 P2d 846 (1988), *cert dismissed* 490 US 1032 (1989). Whether a law violates the provision, requires a two step analysis: (1) is there a contract; and (2) has the law, in question, impaired any obligation of that contract. *Hughes v. State of Oregon*, 314 Or 1, 14, 838 P2d 1018 (1992).

General principles of contract law govern both inquiries, even where the state is alleged to be a party to the contract. *Id.* However, the following additional rules apply: (1) a state contract will not be inferred from legislation that does not unambiguously express an

intention to create a contract; (2) the Contract Clause does not limit the state's power of eminent domain; and (3) the state may not contract away its "police power." *Id.*

In determining whether a particular statute unambiguously expresses an intent to be contractual in nature, "the context in which the * * * statute is enacted is of primary importance." *Id.* at 25. The statute must not be examined in isolation but rather, the analytically proper approach is to examine it within the broader context of the Act into which it is enacted. Id. Where the Act itself is found to be supported by the requisite contractual intent, "[e]very valuable privilege given by the [Act], * * * is a contract which cannot be changed by the Legislature, where the power to do so is not reserved in the * * * [Act]." *Id.* at 24, *citing The Piqua Branch of the State Bank of Ohio v. Knoop*, 57 US 369, 379-380, 14 L Ed 977 (1853).

The contractual obligation may also not be avoided by reliance on the "police power" doctrine, where the police power alleged to be implicated is the state's inherent power to enact laws and regulations to protect the vital interests of the people. *Eckles*, 306 Or at 399. For, as this court has emphasized,

> "the 'police power' is indistinguishable from the state's inherent power to enact laws and regulations; the existence of the power cannot explain the extent to which the power is constitutionally limited. * * * [T]he state cannot avoid a constitutional command by 'balancing' it against another of the state's interests or obligations, such as protection of the 'vital interests' of the people. Limits on the contractual obligations of the state must be found within the language or history of Article I, Section 21, itself."

(citations omitted) *Id.* The language and history of Article I, Section 21, have been found not to allow the "police power" doctrine to be stretched so far as to permit the state to disregard a statutory financial guarantee to persons or corporations participating in a state insurance

system to remedy a financial crisis in the name of protection of the vital interests of the people. 306 Or at 399.

Finally, with regard to the second step of the analysis (i.e., whether the legislation impairs a contractual obligation), the key is to determine whether the state has eliminated any contractual obligation. *E.g., Eckles*, 306 Or at 399-401. A contractual obligation consists of the legal duties imposed on the contracting party by operation of law. *Id.* at 400. These legal duties include the requirement that a breaching party compensate the non-breaching party for its failure to perform pursuant to the terms of the contract. *Id.* If the law eliminates a basis for the contractual liability, there is an impairment. *Hughes*, 314 Or at 31-32. If the basis for contractual liability continues to exist but the law mandates non-performance, there is a breach. *Id.*

For the reasons explained further below, it is beyond dispute that the PERS Act is contract such that petitioners rights to PERS benefits are protected by Article I, Section 21, and Sections 1, 3, 5,6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 impair well-established obligations of that contract in violation the of the Oregon Constitution and/or at a minimum, breach that contract. This court should declare either that the challenged provisions violate Article I, Section 21, and thus are void, as applied to petitioners' contracts, or that the challenged provisions breach that contract such that petitioners are entitled to a remedy.

2. The PERS Act is a Contract Subject to the Protection Against Subsequent Impairment of Article I, Section 21, of the Oregon Constitution.

Whether the PERS Act unambiguously creates contractual obligations that are owed to petitioners and entitled to protection under Article I, Section 21, cannot reasonably be

disputed. Indeed, for more than 60 years, this court has recognized that public employees such as petitioners have a vested right in their pensions. *See Oregon State Police Ass'n v. State*, 323 Or 356, 918 P2d 765 (1996); *Hughes v. State*, 314 Or 1, 838 P2d 1018 (1992); *Taylor v. Mult. Dep. Sher. Ret. Bd.*, 265 Or 445, 510 P2d 339 (1973); *Harryman v. Roseburg Fire District*, 244 Or 631, 420 P2d 51 (1966); *Crawford v. Teachers Retirement Fund Ass'n*, 164 Or 77, 99 P2d 729 (1940).

Beginning, in 1940, with *Crawford v. Teachers' Ret. Fund Ass'n*, 164 Or 77, 99 P2d 729 (1940), this court denied a defendant retirement association the right to withhold a pension annuity from a retired teacher based on amendments to its plan which went into effect following her retirement. Rejecting the retirement association's argument that the post-retirement amendment was valid, this court held that the amendment to the by-laws impaired the employee's vested contractual rights, explaining:

> "In our opinion, when, under the plan authorized by the statute, plaintiff voluntarily contributed a substantial part of her salary to this fund, contractual relations with the association were created. * * * [W]hen there had been full performance on the part of the plaintiff, in compliance with the by-laws then governing the association, her rights became vested and no subsequent change in the by-laws could interfere with or impair such rights. Any other rule would utterly destroy all stability and security in the retirement fund plan under consideration."

164 Or at 86-87.

While the *Crawford* case predates, and therefore did not directly involve, PERS, it is significant in that it established the contractual nature of statutorily created or authorized retirement plans. Notably, just a few years after *Crawford*, the legislature enacted the initial PERS Act. OCLA § 90-714 (1945). Thus, the legislature, when it first enacted PERS, was well aware that the Act would create contractual rights in PERS members. *See State v. Waterhouse*, 209 Or 424, 436, 307 P2d 327 (1957)(recognizing a presumption that statutes

are enacted by the legislature "in the light of such existing judicial decisions as have a direct bearing upon [those statutes]").

This court continued to recognize the expansive contractual nature of pensions in *Harryman v. Roseburg Fire District*, 244 Or 631, 420 P2d 51 (1966). There, the issue was whether an employee was entitled to receive payment for unused sick leave at the end of his employment where a provision in effect at the time he accepted employment provided for such payment, but the provision was repealed during his employment. This court rejected the defendant's argument that the sick leave provision was a gratuity, and instead found that the provision for sick leave was a part of Harryman's compensation to which he became entitled upon acceptance of employment. As this court stated, the sick leave provision "can be regarded as a contractual term of plaintiff's employment. Defendant could not, therefore, deprive plaintiff of the allowance after he had earned it." *Id.* at 634-35.

Several years later, this court decided *Taylor v. Multnomah County Deputy Sheriff's Retirement Board*, 265 Or 445, 510 P2d 339 (1973). In that case, the plaintiff had been employed since 1956 in the Multnomah County Sheriff's Office, performing her duties under a commission and oath as a deputy sheriff. Some years later, an ordinance was enacted providing for a retirement system for Multnomah County deputy sheriffs. Nonetheless, and despite the plaintiff's demand to participate in the new retirement system, the defendants refused to allow her participation, arguing in part that there was no consideration to support any contractual relation between the plaintiff and the pension board. *Id.* at 447-49. Citing *Crawford* and *Harryman*, this court reiterated that public pensions are not mere gratuities, but instead create contractual rights between an employee and employer. Moreover, said this court, such contractual rights may vest prior to retirement, subject only to the subsequent

completion of the employee's service. *Id.* at 450-51. Pension Plans are offers for a unilateral contract which may be accepted by tender of part performance. *Id.* at 452. Thus, this court clearly and unequivocally acknowledged that public employees, through performance, obtain contractual rights to future benefits for both past and future service.

In 1992, this court directly addressed the contractual nature of PERS in *Hughes v. State of Oregon*, 314 Or 1, 838 P2d 1018 (1992). *Hughes* involved legislation that rendered PERS benefits subject to state income taxation where, previously, those benefits were statutorily exempt under ORS 237.201 (1989). This court reviewed its prior pension decisions, including *Taylor*, as well as the history surrounding the enactment of the 1953 PERS Act and found "an underlying legislative intent to create contract rights in PERS employees." *Id.* at 18. Therefore, it held that: (1) an employee's contract rights in PERS become vested at the time of acceptance of employment; and (2) upon vesting, the employee's contract rights "may not be substantially impaired by subsequent legislation." *Id.* at 20. Analyzing the tax exemption statute, then, in relation to its context within the PERS Act, which as a whole was found to be supported by the requisite legislative contractual intent, this court concluded that the tax exemption statute was an integral part of the PERS Act and therefore, a term of that contract. *Id.* at 25. In reaching this conclusion, this court cited with approval to the analysis employed by the United States Supreme Court in *Piqua*, 57 US 369, another case involving a repeal of a tax exemption. *Id.* at 23-25. This court emphasized that the court in *Piqua*, had:

> "concluded that the tax limitation statute 'does not import to be a legislative command nor a rule of taxation until changed, *but a contract stipulating against any change*, from the nature of the language used and the circumstances under which it was adopted.'" *Id.* at 382 (emphasis added).

Id. at 24-25. Applying the same analysis to the context and purpose of the PERS Act, this court held that:

> "the fact that *former* ORS 237.201 was enacted as part and parcel of the Public Employes' Retirement Act of 1953 lead to a conclusion that *former* ORS 237.201 is a term of the larger PERS contract. Only by looking at the statute in isolation, as the state asks us to do, could one escape this conclusion. Such an exercise is, however, is not analytically proper or helpful. Consequently, we hold that PERS was intended to be and is a contract between the state and its employees, and that *former* ORS 237.201, enacted as an essential part of and within the context of that contract, is a term of that contract."

Id. at 25. Turning, finally, to the specific text of that term of the contract, this court found language limiting the contractual promise of tax exemption to benefits that had "accrued" and "were accruing." *Id.* at 27-29. Properly understood, therefore, *Hughes* stands for the proposition that, in an already-contractual scheme such as PERS, in the *absence* of language in a particular provision plainly disclaiming or limiting the extent of the contractual obligation, the provision must be applied to all benefits, including benefits for service to be performed in the future. *See id.* at 21-22, n27 (noting that the contractual nature of tax exemption provision of the type at issue "follow[] from the fact that they were part of a larger contract, not that they were promissory in and of themselves"); *see also id.* at 24-25 (citing with approval to the conclusion of the United States Supreme Court in *Piqua*, that every privilege given by the charter in question was a contract that could not be changed by the legislature where the power to do so was not expressly reserved by the charter).

Finally, most recently, in *Oregon State Police Officers' Association v. State of Oregon*, 323 Or 356, 918 P2d 765 (1996), this court again addressed the contractual nature of PERS. At issue in that case was Ballot Measure 8, which would have eliminated the Tier

One earnings guarantee and 6 percent employer pick-up, and prohibited the use of unused sick leave to increase retirement benefits.

Specifically, with regard to the 6 percent pick-up, this court explained that the change mandated by Measure 8,

> "alters the state's contractual obligation, in violation of *Taylor*, by increasing plaintiff's costs of retirement benefits for services that, absent lawful separation of employment, they will provide in future. That consequence, if approved, would permit the state to retain the benefit of plaintiffs' labor, but relieve the state of the burden of paying plaintiffs what it promised for that labor. That result would frustrate plaintiffs' reasonable contractual expectations that were based on legal commitments expressly made by the state."

Id. at 374-375. Because Measure 8 increased the cost of participation to the employee while decreasing the benefits the employee would ultimately receive upon retirement, this Court concluded that, "[u]nquestionably, Section 10 impairs the obligation of plaintiffs' PERS contract." *Id.* at 375.

Similarly, with regard to the guaranteed rate, this court explained that the 1975 legislature enacted ORS 237.277 and that the effect of this provision was to guarantee a minimum rate of return on the individual account of each PERS member. *Id.* at 377. Additionally, although the state conceded the point, this court expressly recognized that "guaranteed minimum rate of return became a contractual obligation of the state under PERS * * *." *Id.* Finally, because Measure 8 "would cancel the obligation after employees partially performed," this court concluded that it impaired the obligation of the PERS contract. *Id.* at 378.

Finally, with regard to the sick-leave provisions, this court noted that these

> "provisions of ORS 237.153 evince a clear and unambiguous intention of the legislature for the state to become contractually obligated to plaintiffs in the event that the state requested participation in the sick leave credit program. * *

employment, thus preventing a unilateral change by the employer to the plaintiff's detriment during the period of employment."

Id. at 378-379. In reaching this conclusion, this court relied primarily upon its prior ruling *Harryman*, noting that, "although the employer in *Harryman* had a legal right to cancel its sick leave credit authorization at any time, this court held that the relevant question was whether the authorization was in effect at the start of the plaintiff's employment." *Id.* at 379.

Although *OSPOA* was decided based on the federal constitution's contract clause,[22] this court's discussion serves to further clarify the contractual nature of PERS, and the protection to which PERS members' benefits are entitled. First, this court unequivocally confirmed that contractual rights to PERS benefits may be established before the completion of the service necessary to actually receive the benefits. 323 Or at 367. Second, citing *Taylor*, this court confirmed that partial performance by the employee creates vested rights that cannot be subsequently impaired. *Id.* at 369-70. This court stated:

> "The common thread running through the Oregon cases cited above is that the state may undertake binding contractual obligations with its employees, including benefits that may accrue in the future *for work not yet performed.* Moreover, the cases recognized that the PERS pension plan is an offer for a unilateral contract which can be accepted by the tender of part performance by the employee."

Id. at 371 (emphasis in original). It explained further that:

> "Once offered and accepted, a pension promise made by the state is not a mirage (something seen in the distance that disappears before the employee reaches retirement). * * * A contrary holding would serve notice on any person who might consider embarking on a career prove to be worthless, even

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[22]The federal contract clause analysis is similar to Oregon's. The primary distinction is that federal courts balance the state's interest against impairment. The distinction is discussed in greater detail below at 55-57.

> "The board shall provide for an individual account for each member of the system. The account shall show the amount of the member's contributions to the fund and the interest which they have earned * * *"

(emphasis added). Following this, substantive changes have been minimal, until the 2003 legislation.

Section 1 of HB 2003, as amended by HB 3020, changes ORS 238.200 to eliminate all future contributions to the ORS 238.250 regular account, as follows:

> "(4) Notwithstanding subsections (1) to (3) of this section, a member of the system, or a participating employer acting on behalf of the member pursuant to ORS 238.205, is not permitted or required to make employee contributions to the fund for service performed on or after January 1, 2004 * * *"

Or Laws 2003, ch 67, §1, ch 625, §9. Petitioners' 6 percent contributions will now be diverted to a separate account which will be payable as a lump-sum with no employer match or cost of living adjustment. JER-62.

As a result of this diversion, most mid-career employees will lose the option of retiring under Money Match and will find their benefits calculated under the less generous full formula benefit. JER-62. Under ORS 238.300 (2001), however, petitioners were promised calculation of their benefits under the formula which would produce the highest value. That statute expressly provided that petitioners,

> "shall receive a service retirement allowance which shall consist of the following annuity and pensions:
>
> (1) A refund annuity which shall be the actuarial equivalent of accumulated contributions by the member and interest thereon credited at the time of retirement, * * *
>
> (2)(a) A life pension (nonrefund) for current service provided by the contributions of employers, which pension, subject to paragraph (b) of this subsection, shall be an amount which, when added to the sum of the annuity under subsection (1) of this section * * * results in a total of:

> (A) For service as a police officer or firefighter, two percent of final average salary multiplied by the number of years of membership in the system as a police officer or firefighter before the effective date of retirement. * * *
>
> (C) For service as other than a police officer, firefighter or member of the Legislative Assembly, 1.67 percent of final average salary multiplied by the number of years of membership in the system as other than police officer, firefighter or member of the Legislative Assembly before the effective date of retirement
>
> (b) a pension under this section shall be at least:
>
> (A) The actuarial equivalent of the annuity provided by the accumulated contributions of the member.
>
> (B) For a member who has made contributions before August 21, 1981, the equivalent of a pension computed pursuant to this sub-section as it existed before that date. * * *"

(Emphasis added). By diverting their contributions, Section 1 of HB 2003, effectively denies petitioners the contractual protection afforded by ORS 238.300(2)(2001).

The loss suffered by the individual Strunk petitioners, attributable to this change alone is substantial and is outlined at pages 92 to 98 of the Special Master's report. JER-92-98. Specifically, Petitioner Richard Strunk will lose approximately $114 per month or 4.45 percent of his estimated monthly benefit; (JER-93); Petitioner William Smee approximately $304 per month or 5.99 percent of his estimated monthly benefit; (JER-94); Petitioner Donald Reed approximately $532 per month or 14.66 percent of his estimated monthly benefit; (JER-94); Petitioner Larry Blumenstein approximately $461 per month or 9.26 percent of his estimated monthly benefit; (JER-95); Petitioner Alan Lively approximately $460 per month or 7.68 percent of his estimated monthly benefit; (JER-96); Petitioner Marlene Martin approximately $232 per month or 16.74 percent of her estimated monthly benefit; (JER-96); and Petitioner Susanna Rhodes approximately $292 per month or 3.47 percent of her estimated monthly benefit (JER-97).

The foregoing impact on Strunk petitioners is typical of the impact predicted for most mid-career employees by the PERS actuary in his analysis for the legislature. JER-177. On a system-wide basis, the actuary estimated that this provision would reduce employer contribution rates by only 0.98 percent of payroll but reduce benefits to PERS members in an amount greater than 1.9 billion dollars.[24] *Id.*

As it did in *OSPOA*, this court should find that this permanent elimination of petitioners' statutory right to receive a pension calculated on the full value of their account including future contributions and earnings thereon , constitutes an impairment of their PERS contract or at a minimum, a breach of the contractual promise that all member contributions and earnings would be directed to and maintained in that PERS member account.

b. HB 2003, Sections 5 and 6–Elimination of Guaranteed Rate; HB 2003, Sections 5 and 6–Elimination of "the Call" for Guarantee; HB 2003, Sections 7 and 8–Change in Method of Crediting.

As explained above, at inception, the PERS Act required that all interest which PERS members' contributions earned be credited to their account with the sole exception of deductions for "administrative expenses." *See* OCLA §90-710(2). In subsequent years, the legislature has provided for the funding of limited reserves which assure or enhance the financial soundness of the system from the earnings of the fund. *See generally* ORS 238.670. Although the language of the reserve accounts provision has changed somewhat over the years, the general nature of the promise– that members are guaranteed all earnings on their

[24]The actuary explained that this figure was the amount by which the provision reduced the unfunded actuarial liability of the system and that the actual loss in benefits to members was an amount greater than this number. Tr. Vol. 2 20-27.

individual accounts, minus allocations for administrative expenses and properly constituted reserves–has not. *See* ORS 238.250 (2001); ORS 238.610 (2001); and ORS 238.670 (2001).

Furthermore, since 1975, with the enactment of the guarantee, Tier One PERS members have been assured that the earnings to be credited annually to their account will be no less than the then existing assumed interest rate. *See* Or Laws 1975, ch. 333 (HB 2507). The legislative history for HB 2507 explains the context and purpose for the enactment of the guaranteed rate as follows:

> "As a result of the stock market decline in the past two years, members of the Public Employees Retirement System have not received any earnings on their account balances for these years. Interest have been earned on bond and other investments in employes annuity accounts, but those earnings have been offset by the decline in stock values.
>
> House Bill 2507, as amended, insures that PERS members will receive earnings at least equal to the assumed interest rate used by PERS, which is currently 5-1/2%. The assumed interest rate is adopted based upon recommendations of the Retirement Fund actuary, and represents the conservative estimate of average earnings the Fund is expected to realize over an extended period of time. If the income credited to the members' account balances in any one year exceeds the earnings available for that purpose, then the difference is made up in the first subsequent year that earnings exceed the assumed interest rate. This difference must be recovered within five years or the employer's accounts will be charged to recover the balance. It is unlikely that this will happen, and there will be ample opportunity to extend this time if necessary. If the income in any year exceeds the assumed interest rate after recovering overdistributions in prior years, the members' accounts are credited with their share of the excess earnings.
>
> In summary, the bill assures a reasonable interest earnings to the members and also permits them to participate in any actual earnings which are in excess of the rate estimated by the actuary."

JER-150 (emphases added).

In accordance with this purpose, therefore, prior to the 2003 legislation, ORS 238.255 (2001) provided, in relevant part, that:

> "The regular account for an active or inactive member of the system shall be examined each year. If the regular account is credited with earnings for the previous year in an amount less than the earnings that would have been credited pursuant to the assumed interest rate for that year determined by the 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 five years."

(emphasis added).[25] Again, the statutory provisions conferring these rights are unquestionably part of the PERS Act, are integral to the calculation of benefits under that Act, use unambiguously promissory language, contain no language excluding contributions attributable to future service from the general contractual protection and no reservation of the right of future amendment.

Nevertheless, following the 2003 legislative enactments, ORS 238.255 now provides, in relevant part, that:

> "(1) The regular account for members who established membership in the system before January 1, 1996, * * * shall be examined each year. If the regular account is credited with earnings for the previous year in an amount less than the earnings that would have been credited pursuant to the assumed interest rate for that year determined by the Public Employees Retirement Board, the amount of the difference shall be credited to the regular account and charged to a reserve account in the fund established for the purpose. In years following the year for which a charge is made to the reserve account, all earnings on the regular accounts of members who established membership in the system before January 1, 1996, * * * shall first be applied to reduce or eliminate the amount of the deficit. Only earnings on the regular accounts of members who established membership in the system before January 1, 1996 * * * may be used to reduce or eliminate the amount of the deficit.
>
> (2) Notwithstanding subsection (1) of this section * * * the board may not credit any earnings to the regular accounts of members who established membership in the system before January 1, 1996 * * * in any year in which there is a deficit in the reserve account established under subsection (1) of this

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[25]Since 1989, the assumed interest rate has been 8 percent. Prior to that, from 1979 to 1989, it was 7.5 percent. And, from 1975, when the guarantee was adopted, to 1978, it was 7.0 percent. JER-20.

> section, or credit any earnings to the regular accounts of those members * * * that would result in a deficit in the reserve account. In any year in which the fund experiences a loss, the board shall charge the amount of the loss attributable to regular accounts of members who established membership in the system before January 1, 1996 * * * against the reserve account.

(emphasis added). According to the information prepared by the PERS Actuary for the legislature, these provisions will:

> "* * *suspend the minimum interest rate as long as there is a Deficit Reserve. Any positive earnings on such accounts shall be used first to eliminate the Deficit Reserve.
>
> When the Deficit Reserve is eliminated, the regular account of active and inactive Tier One members will be credited with actual earnings up to the assumed interest rate. If the actual earnings are less than the assumed interest rate, any credit balance in the Gain and Loss Reserve will be used to bring the credited earnings up to the assumed interest rate. However a crediting rate shall not be applied above the amount supported by the Gain and Loss reserve balance, since that would create a Deficit Reserve.."

JER-178-179.

There is no question but that these legislative changes eliminate the requirement that petitioners' member accounts grow at a rate at least equal to the assumed rate annually as promised by the 1975 legislature. Furthermore, by removing the employer Call, these changes eliminate the requirement that after five years, any remaining deficit created by the payment of the guarantee becomes the liability of employers. As explained above, all future deficits will be retired only through earnings on employee accounts. In accordance with these provisions, in 2004, the PERS Board distributed zero earnings to petitioners accounts for the 2003 earnings. JER-32.

The loss suffered by the individual Strunk petitioners, attributable to these sections of HB 2003 is, again, substantial and is outlined at pages 92 to 98 of the Special Master's report. JER-92-98. Specifically, Petitioner Richard Strunk will lose approximately $316 per

month or 12.32 percent of his estimated monthly benefit; (JER-93); Petitioner William Smee approximately $924 per month or 18.20 percent of his estimated monthly benefit; (JER-94); Petitioner Donald Reed approximately $595 per month or 16.40 percent of his estimated monthly benefit;(JER-94); Petitioner Larry Blumenstein approximately $904 per month or 18.15 percent of his estimated monthly benefit; (JER-95); Petitioner Alan Lively approximately $1,109 per month or 18.52 percent of his estimated monthly benefit; (JER-96); Petitioner Marlene Martin approximately $223 per month or 16.09 percent of her estimated monthly benefit; (JER-96); and Petitioner Susanna Rhodes approximately $1,665 per month or 19.79 percent of her estimated monthly benefit (JER-97).

On a system-wide basis, the PERS actuary estimated that this provision would reduce benefits for PERS members in amount greater than 4.5 billion dollars. JER-178-179. Additionally, it would reduce contributions to be made by employers by 4.32 percent of payroll. *Id.*

Again, this court should find, as it did in *OSPOA*, that this elimination of petitioners' statutory right to annual earnings at a rate at least equal to the assumed rate and loss of call protection resulting in a substantial reduction in their promised benefits constitutes an impairment of their PERS contract or at a minimum, a breach of the contractual promise that their accounts would be credited annually with earnings at a rate no less than the assumed interest rate.

c. HB 2003, Section 3--Elimination of Right to Invest in Variable Account.

Since 1967, PERS members have had the right to direct a percentage of their PERS contributions to be invested in equities. Or Laws 1967, ch 622, §24. The bill allowing investment in equities was proposed by employee interest groups and supported by employer

groups. JER-134-141. The stated purpose was to allow employees the opportunity to increase their benefits. *Id.* Over the years, the percentage allowed to be invested in equities has been increased. Or Laws 1973, ch 695, §5.

Thus, prior to the legislative enactment, ORS 238.260(3)(a) expressly provided, in relevant part, that:

> "A member may elect at any time to have 25, 50 or 75 percent of contributions by the member to the fund on or after the effective date of the election paid into the Variable Annuity Account, credited to a variable account, and reserved for the purpose of a variable annuity. A member who has elected to have a percentage of contributions so paid, credited and reserved may elected at any time thereafter to have an additional 25 or 50 percent of contributions by the member, but not to exceed 75 percent, so paid, credited and reserved. An election shall be in writing on a form furnished by the board and be filed with the board. An election shall be effective on January 1 following the filing thereof"

(emphasis added). Again, the statutory provisions conferring these rights are unquestionably part of the PERS Act, are integral to the calculation of benefits under that Act, use unambiguously promissory language, contain no language excluding contributions attributable to future service from the general contractual protection and no reservation of the right of future amendment.

Following the 2003 legislative enactment, however, ORS 238.260 now provides, in relevant part, that:

> "(3)(b) Notwithstanding any other provision of this section, a member may not contribute to the Variable Annuity Account after December 31, 2003."

(emphasis added). The amendment, thus, in effect eliminates the right previously granted to make an election to the variable account "at any time thereafter."

Of the Strunk petitioners, petitioners William Strunk and William Smee were invested in the variable account and will no longer be able to do so. Investment in the

variable account, as expected, has been an effective way for PERS members to boost their benefits. JER-39-38, JER-170. As a result of HB 2003, however, Petitioners Strunk and Smee will no longer have that opportunity.

This court should find elimination of this right to constitute an impairment of contract, or at a minimum, a breach of petitioner Strunk and Smee's PERS contracts.

d. HB 2003, Sections 9 and 10–Elimination of COLA; HB 2003, Section 14b *City of Eugene* Remedy-- Elimination of COLA.

Under PERS as it existed prior to the 2003 legislation, retirees were entitled to receive annual cost of living adjustments:

> "As soon as practicable after January 1 each year, the [Board] shall determine the percentage increase or decrease in the cost of living for the previous calendar year . . . .Prior to July 1 each year the allowance which the member or the member's beneficiary is receiving or is entitled to receive on August 1 for the month of July shall be multiplied by the percentage figure determined, and the allowance for the next 12 months beginning July 1 adjusted to the resultant amount."

ORS 238.360(1) (2001) (emphasis added). The increase was limited to a maximum of two percent per year. *Id.* § (2).[26] Cost of living adjustments were paid from contributions by the public employers. *Id.* § (4). The statute providing for cost of living adjustments first became part of the PERS statutes in 1971. Or Laws 1971, ch 738, § 11. Although renumbered in 1995, the COLA provision has not changed in any material way since its enactment.

Under *OSPOA* and *Hughes*, the COLA provision plainly is a term of the PERS contract. It was enacted as part of the larger PERS scheme, and has been in place for over thirty years. Moreover, there is nothing in the language of ORS 238.360 to indicate that the

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[26]The statute further provides for COLA to be "banked" such that, in years where the Consumer Price Index exceeds two percent, the excess is accumulated and applied in years where the Consumer Price Index is less than two percent. ORS 238.360(3).

legislature intended for COLA not to be a part of the contract, or otherwise to be limited. In fact, the statute contains the same type of mandatory language that this court found persuasive in *Hughes*: the PERS Board *shall* determine the amount of the increase and *shall* apply it to retirees' accounts on an annual basis. *See Hughes*, 314 Or at 26. There is nothing within ORS 238.360 that indicates that the legislature intended to retain the ability to deny COLA at any point in the future.

For it to do so now, after petitioners have fully-performed under the contract, in reliance upon the promise, is insupportable. Their right to receive a retirement allowance based on their final PERS account balance and earnings, and to receive annual COLA on retirement benefits for the duration of retirement are terms of petitioners PERS contracts that cannot be impaired significantly by the 2003 legislation (or any other subsequent legislation, for that matter).

Sections 9 and 10 of HB 2003 breach and/or impair petitioners contractual rights to receive COLA. Those sections directly impact only those Tier One PERS members who retired between April 1, 2000 and April 1, 2004. Or Laws 2003, ch 67, § 10(5). For affected members, the new legislation (1) recalculates the member's retirement allowance as if the member's account had been credited with earnings of only 11.33 percent for the 1999 calendar year (instead of the 20 percent actually credited) [*id.* § (2)(a) & (b)]; (2) adjusts the member's newly recalculated, lower retirement allowance with COLA for each calendar year since the member's retirement [*id.* § (2)(d)]; (3) freezes the member's current retirement allowance [*id.* § (3)]; and (4) suspends all further COLA until such time as the newly calculated retirement allowance catches up with the frozen current retirement allowance [*id.* § (4)].

Section 14b(1)(a) of Oregon Laws 2003, chapter 67, also suspends COLA, but it is different in at least one key respect. By its express terms, it will become effective only if PERB "is required to correct one or more of the erroneous benefit calculation methods identified in *City of Eugene, et al. v. State of Oregon*." *Id.* § 14b(1).[27] At this point, it is far from clear whether this contingency has or will occur. The legislation does not explain what needs to happen before PERB is "required" to correct errors. Arguably, section 14b is inoperative at this point because, as the Special Master found, PERB and the petitioners in the *City of Eugene* case entered into a settlement agreement, the terms of which provide that PERB will not take action under section 14b. JER-68.

To the extent section 14b(1)(a) is already in effect, or would come into effect, it, too, operates to suspend COLA for petitioners Denise Jacobsen and Carol Booker and other retirees:

> "The board may withhold cost of living increases under ORS 238.360 from the retired member whose benefit is greater than the correctly calculated benefit of the member until such time as the member's benefit is equal to the correctly calculated benefit."

Id. § 14b(1)(a).

At the very least, the challenged provisions force PERB to breach the state's obligation to provide retirees such as petitioners with annual cost of living adjustments. The legislation requires PERB to suspend such payments, and the evidence presented at the fact finding hearing was that COLA indeed has been suspended as to affected retirees, including petitioners Denise Jacobsen and Carol Booker. JER-237-238. As the Special Master found,

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[27]The impact of the *City of Eugene* litigation on the present dispute is discussed in more detail below at 70-74. That case is also currently on appeal before this court (Supreme Court Case No. S50617).

since August 2003, petitioners have received a lower monthly retirement payment than they would have absent the new legislation. JER-97-98. In fact, petitioners Jacobsen and Booker will not receive a COLA for a period of several years. JER-237-238. This is a textbook example of breach of contract through legislative action. The court should so find, and declare that petitioners are owed a remedy.

Moreover, the legislation works an impairment on petitioners' PERS contract rights. By freezing their current retirement allowance amount and suspending COLA until such time as the newly calculated amount (which is based on a smaller account balance) catches up, the legislature has taken away approximately four years of COLA benefits to which they were entitled prior to the passage of the 2003 legislation. Worse yet, however, the legislation effectively lowers their account balance for purposes of calculating future retirement payments and COLA. *See* JER-118. Under the new legislation, petitioners will always have their future COLA payments (once they resume) calculated based on a lower principal amount than the actual account balance she had at the time of retirement. Because COLA compounds, the gap between what they would have received under ORS 238.360 (2001) and what they will receive under the new legislation will continue to grow. JER-118. The loss of the compounding benefit makes the impairment substantial. As the Special Master found, COLA benefits have substantial value to retirees; what may look like a small impact at first blush will, over the years, "amount to tens of thousands of dollars." *Id.*

The specific impact on petitioners Booker and Jacobsen is outlined at pages 97-98 of the Special Master's report. JER-97-98. Although petitioners Jacobsen and Booker initially only lose $16 and $10 respectively, as petitioners' actuarial expert explained, that loss "continues and increases for as long as [petitioners] survive * * *." JER-237-238.

Furthermore, on a system-wide basis, the PERS actuary recognized that this provision would result in a reduction of over 413.7 million dollars in COLA benefits to PERS retirees. JER-178.

Accordingly, the legislation does more than breach petitioners' right to receive COLA for a few years; it impairs the right for them to receive COLA calculated on their actual account balance, and thus, to receive the compounding benefit over time to which they were entitled. It follows that sections 9, 10 and 14b(1)(a) of Oregon Laws 2003, chapter 67, violate the Article I, Section 21, and should be declared void as applied to petitioners Jacobsen and Booker.

e. HB 2003, Section 14b(1)(b) & (b)(2) *City of Eugene*–Change to Administrative Expenses.

As explained above, the section 14b provisions challenged were allegedly designed to remedy violations found to exist by the Marion County Circuit Court in the *City of Eugene* case. In addition to elimination of COLA from retirees under section 14b(1)(a), discussed above, sections 14b(1)(b) and 14b(2), further require the PERS Board to treat any benefit found to have been erroneously paid to retirees as an "administrative expense" to be "paid exclusively from future income of the Public Employees Retirement Fund" and "in no event" to be considered an "employer liability or charged to employers through employer contributions." Or Laws 2003, ch 67, §14b(2), as amended by ch 625, §31(2). The challenged provisions do not specify which errors found by the Marion County Circuit Court may be treated as administrative expenses. Consequently, it is arguable that these provisions allow recovery above and beyond that envisioned by the COLA provisions.

As explained above at page 31, A32 prior to the legislative change, petitioners were guaranteed that all earnings on their individual accounts, minus allocations for administrative

expenses and properly constituted reserves, would be credited to their member accounts, on an annual basis. ORS 238.250 (2001); ORS 238.610 (2001); and ORS 238.670 (2001). More specifically, ORS 238.610(2001) expressly provided, in relevant part, that:

> "(1) The administrative expenses of the system shall be paid from interest earned by the retirement fund; provided, that if such interest be insufficient the expense in excess thereof shall be paid from the contributions which this chapter requires participating employers to pay into the Public Employees Retirement Fund. * * *
>
> (4) Amounts payable as refunds and retirement allowances shall not for any purpose be deemed expenses of the board * * *"

(emphasis added). The requirement that some payments to retirees be recovered from active members under the guise of administrative expenses is directly contrary to this statutory language which provides that retiree payments "shall not for any purpose" be considered administrative expenses. These provisions are, yet again, an integral part of the PERS Act, impact the calculation of benefits under the Act, are unambiguously promissory in nature, and contain no language limiting them from the general contractual promise and no reservation of the right of future amendment.

Nevertheless, the legislative enactment not only relieves employers of their general responsibility to make the fund whole for deficiencies relating to retirees but also eliminates their obligation to share in any administrative expense deductions attributable to them. In contrast, employees who were previously promised that such retiree payments would not for any purpose be charged as administrative expenses against their account earnings are now exposed to additional reductions in their earnings which are not even arguably attributable to them. This court must find this further reduction of current member accounts to constitute an impairment of their PERS contract in violation of Article I, Section 21, or at a minimum, a

breach of the contractual provision that such expenses would never be deemed expenses of the board chargeable to current PERS members, including petitioners.

f. HB 2004, Section 4--Retroactive Change of Actuarial Equivalency Factors.

Since the inception of PERS, from time to time,[28] the PERS Board, upon the recommendation of the actuary, has adopted actuarial equivalency factors to be used in the administration of the fund. *See generally* OCLA §90-714; ORS 237.071(4)(1953); ORS 238.630(3)(g)(2001). Actuarial equivalency factors are calculated based on two assumptions: one concerning the future earnings of the system and the second relating to the mortality of the members. Tr. Vol. 1 165-177. Actuarial equivalency factors are used in the calculation of benefits, both in converting lump sums to monthly payments as well as in converting between the various optional forms of retirement benefit payment. *Id.* In the PERS system actuarial equivalency factors play a significant role because two of the three forms of benefit, money match and pension plus annuity, are calculated using the system's actuarial equivalency assumptions. *Id.*

Prior to the effective date of the legislative enactment, the board's regulations expressly promised petitioners that:

> "(4)(b) All changes to the System's actuarial equivalency factors shall be prospective only for that portion of an allowance attributable to service as an active member beginning on or after the effective date of the change.
>
> (5) Notwithstanding subsection (4)(b) of this rule, for members who established membership in PERS before January 1, 1999, as described in Oregon Laws 1995, Chapter 654, Section 2, the Board shall not change a

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[28]The Special Master's report at pages 35-39 contains a detailed review of the history of the board's adoption and amendments to these factors. Petitioners accept that summary as accurate. JER-35-39.

> factor that would produce a lower periodic or single benefit payment, and any change of factor(s) shall apply to the total allowance payable.

See OAR 459-005-055 (1996)(emphasis added). ORS 238.630(3)(g) (2001) gave the PERS Board the absolute authority to establish these "actuarial equivalency factors" for the system and mandated that such factors "shall constitute a part of the system." (Emphasis added). ORS 238.650(2)(2001) further made clear that all "rules adopted by the board become a part of the written plan document of the Public Employees Retirement System for the purpose of the status of the system and the Public Employees Retirement Fund as a qualified governmental retirement plan and trust under the Internal Revenue Code and under regulations adopted pursuant to the Internal Revenue Code."[29]

Having provided petitioners assurances of the PERS Board's authority to act through these integral provisions of the PERS Act, section 4 of HB 2004, now eliminates the promises made by the board through OAR 459-05-055 (1996). Despite, the "look back" protection–which does not even provide for accrual of interest on the pre-enactment account balance--application of the new equivalency factors results in a substantial reduction in petitioners monthly benefit.

The loss suffered by the individual Strunk petitioners, attributable to these sections of HB 2003 is, again, substantial and is outlined at pages 92 to 98 of the Special Master's report. JER-92-98. Specifically, Petitioner Richard Strunk will lose approximately $115 per month or 4.49 percent of his estimated monthly benefit; (JER-93); Petitioner William Smee approximately $425 per month or 8.37 percent of his estimated monthly benefit; (JER-94);

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[29]Strunk petitioners also incorporate by this reference all arguments raised by petitioner *Dahlin* with regard to contractual obligations owed petitioners by virtue of the tax qualified status of PERS under the Internal Revenue Code.

Petitioner Donald Reed approximately $255 per month or 7.03 percent of his estimated monthly benefit;(JER-94); Petitioner Larry Blumenstein approximately $190 per month or 3.81 percent of his estimated monthly benefit; (JER-95); Petitioner Alan Lively approximately $229 per month or 3.82 percent of his estimated monthly benefit; (JER-96); Petitioner Marlene Martin approximately $98 per month or 7.07 percent of her estimated monthly benefit; (JER-96); and Petitioner Susanna Rhodes approximately $321 per month or 3.82 percent of her estimated monthly benefit (JER-97).

On a system-wide basis, according to information provided by the PERS actuary to the legislation, this section alone would reduce benefits for members in an amount greater than 1.588 billion dollars. JER-176. Furthermore, it reduced employer contribution rates by approximately 1.49 percent of payroll. *Id.*

This court should find that this elimination of petitioners' right to have no factors applied to their account balances which would result in a lower benefit amount resulting in a substantial reduction in their promised benefits constitutes an impairment of their PERS contracts or at a minimum, a breach of the contractual promise provided by OAR 459-05-055 (1996).

D. Conclusion.

Because for all the reasons explained above, it is beyond dispute that PERS is a contract such that petitioners rights to PERS benefits are protected by Article I, Section 21, and Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 impair well-established obligations of that contract in violation of the Oregon Constitution and/or at a minimum, breach that contract, this court should declare either that the challenged provisions violate Article I, Section 21, and thus, are void as applied to petitioners' contracts,

or that the challenged provisions breach that contract such that petitioners are entitled to a remedy.

III. SECOND ASSIGNMENT OF ERROR.

Second Assignment of Error. Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 constitute a taking of petitioners' property interest without just compensation in violation of Article 1, Section 18, of the Oregon Constitution.

A. Preservation of Error.

In their petition to this court, the Strunk petitioners alleged that Sections 1, 5,6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 violated Article I, Section 18, of the Oregon Constitution. Those allegations can be found at paragraphs 24, 40, 53, 67, 81, 102, 113, 126, and 140. JER-182-223.

B. Standard of Review.

As explained above, Oregon Laws 2003, ch 67, §37, ch 68, §5, as amended by ch 625, §§17 and 17a, expressly confer jurisdiction upon this court to determine, *inter alia*, whether the provisions "violate any constitutional provision * * *." Although, the legislation authorized this court to appoint a special master in the event it determined there were factual issues in the petition, the special master was only "to hear evidence and prepare *recommended* findings of fact." *Id.* §17(6) and §17a(6) (emphasis added). Therefore, the standard of review is *de novo.*

C. Argument.

Under the Oregon Constitution, "[p]rivate property shall not be taken for public use * * * without just compensation." Or Const, art I, § 18. In this case, petitioners rights to make 6 percent contributions to their PERS member accounts, receive the guaranteed rate of return annually on those accounts with the call protection, have no deductions made from earnings

on those accounts for administrative expenses attributable to retirees or actuarial equivalency factors applied to those accounts which would reduce their retirement allowance, and receive annual upward adjustments on their retirement allowances to account for inflation are protected property rights. The challenged provisions of the 2003 legislation effectively take those property rights from petitioners for what amounts to public use, and petitioners were not provided with any compensation. As a result, the challenged provisions of the 2003 legislation violate Article I, section 18, of the Oregon Constitution, and should be declared void as applied to petitioners PERS contracts.

Property is taken, for purposes of Article I, section, 18, where there has been "destruction, restriction or interruption of the necessary use and enjoyment" of that property for a public purpose. *Hawkins v. City of La Grande*, 315 Or 57, 68, 843 P2d 400 (1992) (quoting *Moeller v. Multnomah County*, 218 Or 413, 431, 345 P2d 813 (1959)). Although most cases arising under the takings clause involve the state's exercise of its eminent domain powers over real property, personal property, too, is protected. *Id.* at 67.

Unlike the takings claim before this court in *Hughes*, the present matter does not involve an exercise of the state's tax power. Instead, it involves legislative enactments that, as described above: (1) eliminate promises made to petitioners regarding 6 percent contributions to their PERS member accounts, the guaranteed rate of return on those accounts, repayment of deficit with regard to those accounts, the method of crediting and deducting administrative expenses from those accounts, the actuarial equivalency factors to be applied to those accounts, and annual upward adjustments on their retirement allowances to account for inflation, and (2) reduces the balance in their accounts for purposes of calculating their future retirement benefits. Plainly, then, the challenged provisions either

destroy, restrict or interrupt petitioners use and enjoyment of those benefits within the definition of a taking supplied by this court in *Hawkins*. Moreover, there is no question that the 2003 legislation takes petitioners' retirement benefits for a public purpose, namely to lessen the growth of retirement benefits and thereby reduce the financial impact of paying those benefits for public employers, and, indirectly, for taxpayers. The preamble to the legislation says as much. Under these circumstances, the court should hold that the challenged provisions of the 2003 legislation work a taking of petitioners' property rights in their PERS benefits without any compensation, and thus violate Article I, section 18, of the Oregon Constitution.

D. Conclusion.

Because for all these reasons, petitioners rights to make 6 percent contributions to their PERS member accounts, receive the guaranteed rate of return annually on those accounts with the call protection, have no deductions made from earnings on those accounts for administrative expenses attributable to retirees or actuarial equivalency factors applied to those accounts which would reduce their retirement allowance, and receive annual upward adjustments on their retirement allowances to account for inflation are protected property rights which are effectively taken for public use without just compensation, this court should find that Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and Section 4 of HB 2004 constitute a taking of petitioners' property interest in violation of Article 1, Section 18, of the Oregon Constitution and declare these provisions void as applied to petitioners' contracts.

IV. THIRD ASSIGNMENT OF ERROR.

Third Assignment of Error. Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(b)&(2) of HB 2003 breach the terms of the *Chess* settlement agreement.

A. Preservation of Error.

In their petition to this court, the Strunk petitioners alleged that Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 breached the *Chess* settlement agreement. Those allegations can be found at paragraphs 32, 46, 59, 73, 87, 119, and 132. JER-182-223.

B. Standard of Review.

As explained above, Oregon Laws 2003, ch 67, §37, ch 68, §5, as amended by ch 625, §§17 and 17a, expressly confer jurisdiction upon this court to determine, *inter alia*, whether the provisions "breach any contract between members of the Public Employees Retirement System and their employers * * *." Although, the legislation authorized this court to appoint a special master in the event it determined there were factual issues in the petition, the special master was only "to hear evidence and prepare *recommended* findings of fact." *Id.* §17(6) and §17a(6) (emphasis added). Therefore, the standard of review is *de novo*.

C. Argument.

In *Hughes*, this court held that imposition of state income tax on PERS benefits accrued prior to September 28, 1991 was a breach of the PERS statutory contract. 314 Or at 1. Because of the limited grant of jurisdiction to this court for a direct appeal on the constitutionality of that enactment, however, this court declined to formulate a specific remedy for that breach, leaving that in the first instance to the Oregon legislature. *Id.* at n36. When the subsequent legislative session failed to enact an appropriate remedy, class action

lawsuits were filed in Marion County Circuit Court seeking a judicial remedy for the breach of contract. These cases will be referred to generically as the *Chess* lawsuits.[30]

The 1995 legislature passed House Bill 3349 (Or Laws 1995, ch 569) which provided in effect that PERS retirees would be given an increase in their retirement benefit for service prior to September 28, 1991 sufficient to alleviate any damages caused by the imposition of tax on those same benefits.[31] Prior to the passage of HB 3349, the PERS actuary informed the legislature that the cost of this additional benefit would require an increase in employer contributions of approximately 1.4 percent of payroll. JER-41; Tr. Vol 1 188.

The next actuarial evaluation of the system, which took place in 1997, generally resulted in an increase in employer contribution rates, the majority of which was directly attributable to the passage of HB 3349. *Id.* The preamble of HB 2003 recites specifically that one of the reasons for the passage of HB 2003 is the rise in cost of providing PERS benefits since 1995. JER-180. Thus, one of the rationales for the passage of HB 2003 is the increase in employer rates directly attributable to the passage of HB 3349, which was passed by the legislature in order to remedy a contract breach by the imposition of taxation on PERS benefits, which this court in *Hughes* found to be a breach of contract. To the extent that the legislature has lowered PERS retirement benefits, at least in part, because of the increase granted by HB 3349, then it has in fact repealed the benefits of HB 3349.

When the legislature passed HB 3349, it clearly retained the right to withdraw that remedy without a breach of any PERS contract right. ORS 238.375(3). Petitioners, in this

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[30]*Chess v. State of Oregon* (Marion County Case No. 94C-11180), *Stovall v. State of Oregon*, (Marion County Case No. 93C-11180).

[31]The full remedy provided for this breach of contract was actually based on action by the 1991 legislature, SB 656. The 1995 legislature, HB 3349, as well as the 1997 legislature, HB 2034; for convenience, these will be referred to generically as the HB 3349 remedy.

case, however, do not ask this court to find that the passage of HB 2003 breached any statutory contract created by HB 3349. Rather, petitioners ask the court to determine that the passage of HB 2003 was a breach of the settlement agreement which concluded the *Chess* litigation. JER-151-160. Petitioners request this court to determine that the passage of HB 2003 breached that settlement agreement by, in effect, withdrawing the benefits of HB 3349 for PERS participants. Such a determination would permit the re-opening of the *Chess* class action in the circuit court in order to pursue an appropriate remedy for the wrongful taxation of PERS benefits. This right to re-open the litigation is specifically preserved both in the settlement agreement as well as in the statute itself. ORS 238.375(4)(b).

D. Conclusion.

For all these reasons, this court should declare that Sections 1, 5, 6, 7, 8, 9, 10, 14b(1)(b)&(2) of HB 2003 breach the terms of the *Chess* settlement agreement for which petitioners are entitled to pursue a remedy as provided under ORS 238.375.

V. FOURTH ASSIGNMENT OF ERROR.

> **Fourth Assignment of Error.** The Special Master erred in not compelling production of opinions of counsel, withheld under a claim of attorney/client privilege, relating to trust administration.

A. Preservation of Error.

Strunk petitioners filed two motions to compel productions of documents withheld by the PERS Board under a claim of attorney/client privilege. The first, filed on December 31, 2003, sought production of the documents on the basis that:

> "Plaintiffs are entitled to production of these documents because the PERB cannot shield legal opinions on plan administration from the beneficiaries PERB is obligated to serve. * * *

> The privilege which protects attorney-client communications may not be used both as a sword and shield."

By order, dated January 21, 2004, the Special Master denied petitioners' motion to compel, based on the "fiduciary exception" to attorney/client privilege, ruling that:

> "The exceptions to Oregon's lawyer-client privilege are confined to those set out in OEC 503(4) and the common-law exceptions to the lawyer-client privilege that the Oregon Courts recognized before the Evidence Code was enacted. Oregon Courts are not authorized to recognize additional exceptions to the privilege, including exceptions recognized by the courts of other jurisdictions before enactment of the code. * * *"

JER-227-236.

Thereafter, on February 24, 2004, Strunk petitioners filed another motion to compel production. In that motion, Strunk petitioners requested production of "advisory opinions from the Attorney General to the PERS Board * * * relating to the adoption of OAR 459-005-0055" on the basis that:

> "the State has argued that the PERS Board acted beyond the scope of its statutory authority. State of Oregon's Hearing Memorandum, p 20. As primary support for that proposition, the State relies upon the decision of Judge Lipscomb in the City of Eugene Case. * * * The State alleges that Judge Lipscomb held that the PERS Board exceeded its statutory authority by guaranteeing PERS members a specific amount of benefits. However, ORS 238.630(3)(h) specifically requires the Board to "adopt rules and take all actions" to maintain the PERS system as an IRS qualified plan. Thus, the State's argument necessarily raises a question as to the authority the PERS Board was operating under when it adopted this and the purpose of the PERS Board in adopting this rule. Any legal opinions indicating that the rule was necessary to maintain the plan as "qualified" would certainly be relevant to the State's defense that the Board exceeded its authority under ORS 238.630(3)(h).
>
> The relevance of those legal opinions is more than mere supposition or speculation. Rather, the State itself has represented that the PERS Board relied on those legal opinions when it adopted this rule. In fact, the State has argued in prior litigation that this decision was made based upon consultation with Department of Justice Attorneys. Specifically, the State has alleged:

> The Board is required by statute – specifically, by ORS 238.630(3)(h) – to "take all actions necessary" to maintain the system as a qualified governmental retirement plan for tax purposes. Again, the legislature has delegated broad discretion to the Board to decide what actions may be "necessary" to retain the qualified status of the plan. This principle limits the Board's discretion in changing actuarial factors because the Board determined – after consulting with tax attorneys from the Department of Justice and retaining a tax law expert from Stoel Rives – that any change in actuarial factors that decreases the retirement benefits that are payable to current PERS members could jeopardize the "qualified" status of the plan for purposes of the Internal Revenue Code. City of Eugene v. State of Oregon, State's Trial Memorandum, p. 18.

Therefore, the any legal opinions on which the Board based its decision to adopt this rule are directly relevant to the defense raised by the State. By making this argument and raising this defense, the State has waived any privilege associated with these opinions."

By order, dated March 9, 2004, the Special Master denied petitioners' motion, ruling that:

"As noted in the ruling on the earlier motions, waiver of the lawyer-client privilege by claim or defense assertion prevents a party from using the advice of counsel both as a sword and a shield. Thus, PERB was warned that it could not assert a belief that it had acted in accordance with the law without also providing to plaintiffs the information on which that assertion was based. Plaintiffs now assert, in essence, that the State of Oregon has snared itself in the trap that PERB avoided. Nothing, however, in the assertions that plaintiffs have identified suggests that the State of Oregon has attempted to inject into these proceedings the issue whether the State of Oregon or PERB *believed* that it was acting according or contrary to law. Instead, those assertions posit only that PERB's conduct, and the 1993 administrative rule that PERB adopted, was inconsistent with applicable legal principles. In this context, that distinction is significant.

Plaintiffs continue, however, that the mere assertion that PERB acted unlawfully makes relevant the legal advice that PERB earlier had received. In particular, they claim that the validity of administrative action, whether in rulemaking or otherwise, somehow can depend on whether the administrative body followed or disregarded legal advice. Plaintiffs, however, provide no authority for that proposition, and the Special Master is aware of none. Whether PERB thought that it was adopting a valid rule in 1993 or whether PERB was well or poorly advised in that undertaking should have no bearing on whether the rule, in fact, was valid. Indeed, counsel for the *Strunk* plaintiffs, Mr. Hartman, clarified that the legal communications he seeks

> would have had no effect on the presentation of evidence in these proceedings; he seeks them only to augment plaintiffs' legal arguments. For those reasons, plaintiffs' assertion of waiver by position assertion is not well taken."

JER-247-254.

B. Standard of Review.

As explained above, Oregon Laws 2003, ch 67, §37, ch 68, §5, as amended by ch 625, §§17 and 17a, expressly authorized this court to appoint a special master in the event it determined there were factual issues in the petition, the special master was only "to hear evidence and prepare *recommended* findings of fact." *Id.* §17(6) and §17a(6) (emphasis added). By order, dated, October 15, 2003, this court further authorized the Special Master to "rule on any prehearing matters." Because the legislative enactment, only authorized the Special Master to make "recommended findings," however, the standard of review is *de novo*.

C. Argument.

By this reference, Petitioners Strunk adopt the arguments raised by petitioner *Dahlin* regarding the denial of petitioners' motions to compel.

VI. COMBINED RESPONSE TO DEFENDANTS ANTICIPATED DEFENSES.

In their answers to the various petitions, respondents,[32] in addition to denying the existence of petitioners' PERS contracts, raised several defenses. Although the precise nature of these defenses will remain unclear until respondents have filed their briefs, the defenses as currently understood lack merit and should be disregarded.

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[32]The League of Oregon Cities and the Oregon School Boards Association intervened in these matters. They, along with the state of Oregon and the Public Employees Retirement Board assert similar defenses, and appear to mount what is in effect a joint opposition to petitioners' challenges. This brief will refer to all of those entities collectively as "respondents" for ease of reference.

A. Economic Hardship Defenses.

Most of the various affirmative allegations might be generically grouped as "economic necessity" defenses. They have both constitutional and common law components that are relevant to this case. Outlined below is a discussion of the constitutional issues followed by an analysis of the common law defenses.

1. Respondents' Constitutional Defenses Lack Merit.

Respondents constitutional defenses reflect a common constitutional theme characterized by the tension between the Contract Clause and the state's police powers. In discussing these legal theories, there are a few basic principles that must be recognized.

First, it is far from clear that Oregon's courts have adopted, or should adopt, the type of balancing test that respondents would have the court apply in this case. Under the analysis employed with respect to the contract clause in the federal Constitution, a substantial impairment of contract rights may be justified if the impairment is both reasonable[33] and necessary to serve an important public purpose. *United States Trust Co. v. New Jersey*, 431 US 1, 27, 97 S Ct 1505 (1977).

In *Eckles*, this court rejected the application of any such balancing test as a means of justifying a state's impairment of its own contractual obligations under the Oregon

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[33]Under the federal analysis, the "reasonableness" of the measure is dependent upon "whether the method used by the state to advance that public purpose constitutes an unnecessarily broad repudiation of its contractual obligations to private persons." *OSPOA*, 323 Or at 364, citing *General Motors Corp. v. Romein*, 503 US 181, 186, 112 S Ct 1105 (1992); *Keystone Bituminous Coal Assoc. v. DeBenedictis*, 480 US 470, 504, 107 S Ct 1232 (1987); *Energy Reserves Group, Inc. v. Kansas Power & Light*, 459 US 400, 411, 103 S Ct 697 (1983); *United States Trust Co.*, 431 US 1. *See* Lawrence H. Tribe, American Constitutional Law, (2d ed 1988)(discussing federal Contracts Clause); *see also*, R. Rotunda, J. Novak, 2 Treatise on Constitutional Law. §15.8 (3d ed 1992) (summarizing relevant Supreme Court cases).

Constitution. 306 Or at 398-99. *Eckles* involved legislation that directed the state treasurer to transfer millions of dollars from the Industrial Accident Fund to the state general fund despite the fact that the Industrial Accident Fund is, by statute, declared to be a trust fund maintained exclusively for certain workers compensation purposes. The transfer legislation was enacted to close a gap in the state budget. *Id.* at 382. The petitioner in *Eckles* brought a challenge to the legislation under the Contract Clause. In discussing the proper Contract Clause analysis, this court observed that the United States Supreme Court, in addressing contract clause challenges under the federal constitution, employs a balancing analysis which considers the "inherent police power of the State 'to safeguard the vital interests of its people.'" *Id.* at 398 (quoting *Energy Reserves Group v. Kansas Power & Light*, 459 US 400, 410, 103 S Ct 697 (1983)). Then, acknowledging that the existing financial crisis[34] might qualify as a vital state interest, this court rejected the application of a balancing test, at least insofar as the state was one of the contracting parties:

> "The need to resolve the financial crisis that induced the Legislative Assembly to pass the Transfer Act could perhaps be described as a 'vital interest' of the state, but we doubt that the 'police power' doctrine could be stretched so far as to permit the state to disregard a financial guarantee to persons or corporations who participate in its state insurance system. In any event, this court has emphasized in recent years that the 'police power' is indistinguishable from the state's inherent power to enact laws and regulations; the existence of that power cannot explain the extent to which the power is constitutionally limited. * * * Moreover, the state cannot avoid a constitutional command by 'balancing' it against another other of the state's interests or obligations, such as protection of the 'vital interests' of the people. * * * Limits on the contractual obligations of the state must be found within the language or history of Article I, section 21, itself."

Id. at 398-99 (internal citations omitted).

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[34]The Special Master found that the financial crisis the state experienced leading-up to the 2003 legislation had less severe overall effects than the 1981-1983 recession–i.e., the financial crisis at issue in *Eckles*. JER-79.

To the extent any doubt remained after *Eckles*, this court put it to rest in *Hughes*. Citing *Eckles*, the *Hughes* court again noted that the so-called "police power" is nothing more than the state's inherent power to enact laws, and that although the state may not contract away its so-called "police power," that rule "does not embrace the 'balancing analysis' currently employed by the Supreme Court of the United States in its analysis of the Contract Clause in Article I, section 10, clause 1 of the Federal Constitution." 314 Or at 14, n 16.

The point is that the exercise of the so-called police power, even in the vital interest of the state and its citizens, cannot operate to carve out certain contract rights from the constitutional protections provided by the Contract Clause and thereby render those rights unprotected. After all, the police power is not a constitutional grant of power, but merely refers to the plenary power of the state to enact laws. *E.g., Eckles*, 306 Or at 399; *see also* Hans A. Linde, *Without "Due Process,"* 49 OR L REV 125, 147-48 (Feb 1970) ("*No constitution, state or federal, grants Oregon or any other state a 'police power.'* There simply is no such thing. What Oregon has, as a state, is plenary power to make and administer law, by means of constitutional institutions and subject to constitutional limitations.") (emphasis in original). It is the constitution that curtails the state's ability to enact laws, and not the other way around. As a result, before this court reaches the issue of whether the state's alleged economic hardship would justify impairing its contractual obligations, it should consider whether such a balancing is proper in the first instance. Based on *Eckles* and *Hughes*, this court should find that no balancing is proper, particularly given, in this matter, that the state was acting as an employer and contracting party in offering PERS benefits in exchange for public employment.

Second, even if this court considers the economic hardship evidence under the federal balancing approach, the state's abrogation of its own contracts must be held to a higher standard than the state's abrogation of private contracts. Accordingly, It is important to look at how the contract clause/police power dichotomy has been addressed in the context of both the state's power to impair private contracts, and the state's power to impair its own contracts. Even though this case involves the latter, it is important to inquire somewhat into the issue of private contracts to put the analysis in context.

Cases from the United States Supreme Court and this court under the federal provision have faced the issue of whether Legislative acts can impair private contracts. Under extreme circumstances, the courts have countenanced a limited impairment of contractual rights, so long as the basic integrity of the contract is preserved. Past cases talked about modifications of contractual remedies as being acceptable, while impairment of the basic obligation was constitutionally impermissible. However, this remedy/obligation distinction has largely been abandoned in favor of a broader approach exploring the reasonableness of the interference, both in terms of the nature of such interference, and the conditions arguably justifying any impairment at all. The fact that an impairment might most directly affect a remedy is still pertinent to whether the interference is constitutionally permissible. *City of El Paso v. Simmons*, 379 U.S. 497, 507-508, 85 S. Ct. 577, 13 L.Ed.2d 446 (1965); *US Trust, supra*, 431 U.S. at 20-24; *Eckles*, 306 Or at 397-399.

Within these parameters, rent controls were countenanced by the United States Supreme Court in light of the exigent circumstances accelerating the need for decent housing in metropolitan areas at the time of World War I. When discussing the need for such controls, the court noted that the problem to be remedied may well be temporary, and acknowledged

that changing circumstances could nullify otherwise valid legislation. The court also noted the protection afforded landlords by independent determinations of a "reasonable rental" to be charged. *Marcus Brown Holding Company v. Feldman,* 256 US 170, 41 S Ct 465, 65 L Ed 877 (1921); *Block v. Hirsh,* 256 US 135, 41 S Ct 458, 65 LEd 865 (1921); *Chastleton Corp. v. Sinclair,* 264 US 543, 44 S Ct 405, 68 LEd 841 (1924). Similarly, at the time of the great Depression, the court recognized the need to extend redemption periods to avoid the numerous foreclosures that were prompted by this singularly catastrophic economic crisis. Even in that environment the court emphasized that the mortgage holder's rights were essentially preserved, and that only the remedy was affected. These suspensions of the parties' strict contractual rights were also temporary adjustments in light of economic emergencies. *See Home Bldg & Loan Ass'n v. Blaisdell*, 290 US 398, 54 S Ct 231, 78 L Ed 413 (1934). In these instances, the crises were well-recognized, and, at least as to these private contracts, the court gave significant deference to the finding of a state of emergency by the Legislature. However, our courts, although acknowledging some deference, have also emphasized and preserved the independent function of the judiciary to properly determine the parameters of the contract. *Lornsten v. Union Fisherman's Co-op Packaging Co.,* 71 Or 540, 546-547, 143 P 621 (1914). Any legislative action restricting such contractual rights are subject to scrutiny by the courts to ensure that such action is reasonable. *General Electric v. Wahale*, 207 Or 302, 320, 296 P2d 635 (1956).

In short, the state's right to interfere with **private** contracts was only recognized in a time of widespread and dire economic crisis. In addition, the nature of the interference was generally temporary, could often be described as only remedial, and did not impair the basic obligations of the contracting parties. This court must remember that these cases are only

discussed to contrast their holdings to those which instead involves the State's attempt to avoid its own contractual obligations. In those settings, which are applicable to the case at bar, the courts employ a much different analytical framework.

Legislative attempts to absolve the state or other public bodies of their financial obligations are subject to much more rigorous judicial scrutiny. In such settings there is an inherent conflict because the state's self-interest is at stake. It is obvious that, under such circumstances,

> "a governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If the State can reduce its financial obligations whenever it wanted to spend money for what it regarded as an important public purpose, the Contract Clause would provide no protection all."

US Trust Co, supra, 431 US 1, 26; *OSPOA v. State,* 323 Or 356, note 12 at 364, 918 P.2d 765 (1996). As a result, when the state is seeking justification for abrogating its own contracts, it must be treated exactly as an individual, and be forced to justify its inability to perform with more than mere reference to the police power, and a desire to spend money in other areas that it feels are more appropriate for the general advancement of the common weal. *United States v. Windstar Corp.,* 518 U.S. 839, 891-892, 895-898, 116 S.Ct 2432, 135 L.Ed.2d 964 (1996) This is particularly true when the government, having assumed contractual obligations, and the risk of untoward circumstances, seeks to abandon these responsibilities, and force "***some people alone to bear public burdens which, in all fairness and justice, should be born by the public as a whole." *Windstar, supra,* 518 US at 883. In addition, as with any contracts between individuals, if there is a risk that some foreseeable event might abrogate a party's performance, then that risk (such as a reduction in public revenue) should be specifically provided for in the contract, or it will be inferred that such risk was assumed by

the party whose performance is arguably made more difficult. *Windstar, supra,* 518 US at 905-906.

The external circumstances justifying the abrogation of a state's contract is very hard to discern, because, in both *U.S. Trust* and *Windstar*, the court found that there was not a sufficient emergency to justify legislation that would substantially impair the government's financial obligations toward private parties--*U.S. Trust* arose during the energy crisis of the earl y 1970's, and *Windstar* involved the S & L debacle of the 1980's. Here, there is no crisis akin to the Great Depression. Moreover, even if the current loss of revenue is seen as a crisis, the remedy sought is the permanent deprivation of billions of dollars from tens of thousands of public employees, with no corresponding benefit. Such remedy would have been summarily rejected had it involved private contracts in the era of the Great Depression. There is no precedent for such action.

Indeed, one of the only cases that allowed a State to abrogate its contract was *City of El Paso v. Simmons, supra.* But *El Paso* involved a Texas statute passed in 1910, which allowed the State Land Board to sell public lands allocated to the Free School Fund. The statute provided for forfeiture back to the State in the event of default. However, there was a perpetual redemption period that allowed for reacquisition by paying the interest due. When oil and gas were discovered, speculators used the statute to tie up land, seek the discovery of minerals, and then buy it back if such riches were found. The statute was thus transformed from a support for schools to a boon to speculators. The Texas Legislature amended the statute to limit redemption to 5 years. Such legislation withstood a Constitutional challenge that it impaired the prior statutory contract made by the State. That unique situation has no

bearing on the present respondents' attempts to avoid their financial obligations at the expense of a limited group of citizens.

In summary, when the state and other governmental bodies are seeking to avoid their contractual obligations, and where the contract does not provide for nonperformance in the event of the unavailability of funds, these governments must be treated essentially as individuals, and cannot rely upon the police power to generally justify their political decisions to allocate funds to different areas. This is particularly true when government, whether viewed in its position as representing the people, or when viewed as the people at large, can not demonstrate an inability to meet its financial obligations, but rather an unwillingness to perform. Such is in fact the situation in this case.

Here, as pointed out in the findings of fact, any shortfall in revenue to meet the contractual obligations of the State and local governments is not based upon any particular economic hardship or inability to pay, but instead primarily reflects the unwillingness of taxpayers to assume the financial burdens associated with this contract. JER-78. Before the passage of Ballot Measures 5 and 50, Oregon was in the upper 10 to 14 states in terms of overall tax burden. Currently, Oregon's tax burden of 10.5 percent of personal income is approximately 0.7 percent less than the national average, and1.6 percent less than it was in 1989. An increase in tax revenues of 0.4 percent, to approximately 10.9 percent of personal income, would be sufficient to fund the entire cost of the invalidation of the challenged legislation. Such an increase would still leave Oregon below the average state and local tax burden of 11.2 percent, and well below the state's burden in 1989 of 12.1 percent. JER-77-78; JER-172. These figures dramatically illustrate that the abrogation of any existing contracts is based upon the State's decision, through its citizens, not to spend money in this area, but

instead to utilize resources differently. The State and other governments are certainly free to change priorities based upon personal or political predilections. However, they cannot choose to abrogate constitutional obligations merely because their desires have changed.

This argument is fully borne out by the evidence concerning the impact of invalidation of the legislation on individual government bodies. Although the absolute numbers are quite large, particularly when projected over time, as percentages they do not rise to the level of a financial crisis or dire economic emergency that would justify breaching otherwise valid contracts. The "cost of invalidating the legislation", amortized over 25 years, is estimated to require 2.4 percent of State and local own source revenue for that period. JER- 81-82. Local governments predict a similar or lesser percentage cost. Roseburg School District estimates that the legislation will save approximately $1.5 million of the total budget of $68,665,000, or about 2.1 percent. JER-84-85. Savings of similar percentages are evidenced elsewhere[35]. These savings can, and were, translated by the respondents into additional fire, police and teachers, or alternatively, to the loss of such services if the legislation is invalidated. Alternative cuts were hardly discussed. Indeed, the rhetoric is the same as that heard in support of tax increases and the need for funds. Although compelling, or not according to one's point of view, none of the dire predictions of impending doom have been borne out in the past, and it is by no means clear that they will occur as predicted by respondents in this case. In fact, many of respondents, have set aside half or more of the savings in reserves pending the outcome of this litigation. JER-84-90. Regardless, these

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[35] Portland School District projected a "legislative savings" of $15 million of a $483 million dollar budget, about 3%; Lane County, $4 million out of out of $458 million; Eugene, $4.2 million out of $356 million; Corvallis, $1.2 million out of about $60 million; Multnomah County, $12 million out of $1 billion. JER-85-90.

estimates of small percentage changes in available funds give no support to a claimed justification for breaching existing contracts and violating the Constitution. They particularly offer no justification when the entire "savings" is borne by a particular group of public employees who receive no corresponding benefits.

2. Respondents' Common Law Contract Defenses Lack Merit.

a. Impossibility and Impracticability of Performance.

There is little if any distinction between the defenses of "impossibility" and "impracticability" as reflected by Oregon law. Their application to this case rests with the economic difficulties[36] associated with performance of the PERS contracts. Generally speaking, "supervening impracticability" or impossibility discharges the duty of a promisor:

> "***where, after the formation of a contract facts that the promisor had no reason to anticipate, and for the occurrence of which he is not in contributing fault, render performance of the contract impossible***."

Savage v. Kiewit and Sons' Co, 249 Or 147, 152, 432 P2d 519 (1967); See also, *Restatement (Second) of Contracts*, § 261[37]. The non-occurrence of such intervening facts must be a basic assumption on which the contract was made[38]. This readily applies in situations involving

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[36] Impracticability includes intervening "acts of God", death or incapacity of a person necessary for performance, and failure of something necessary for performance to come into existence. See *Northwestern Mutual Ins. Co. v. Peterson,* 280 Or 773, 776-777, 572 P2d 1023 (1977); *Restatement*, at §§ 262-262. These circumstances are not present in the instant case.

[37] The *Restatement* at § 261 reads as follows:

"Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary."

[38] See Note 38, *supra.*

the death of a person or the destruction of a specific thing necessary for performance. (*Restatement, supra,* comment b to § 261, at 314). In contrast,

> "(t)he continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts and financial inability do not usually effect discharge***."

Id. The only exception is when the "***unexpected difficulty or expense may approach such an extreme that a practical impossibility exists", and was outside any reasonable contemplation of the parties. *Savage, supra,* 249 Or at 152-153. Oregon cases do not appear to have discharged an obligation based only on economic difficulty, even when the financial burden was extreme. *See Savage, supra.* Indeed, to effect such discharge without very extreme circumstances would be contrary to the basic premise that "(c)ontract liability is strict liability", and that an obligor is liable for breach "***even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated." *Restatement,* Chapter 11, Impracticability of Performance and Frustration of Purpose, Introductory note, at 309.

There is no evidence of a change in financial circumstances that would justify a discharge of respondents' contractual obligations. There have only been fluctuating market forces that had to be anticipated by the obligors. To the extent that the cost of performing the contracts have increased, such increase, although significant[39], is not debilitating, and could never excuse performance of a private contract, much less the obligation of a government entity. *See also Sachs v. Precision Products Co.,* 257 Or 273, 281[40], 476 P2d 199 (1970).

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[39] See Discussion, *post*

[40] The court stated as follows: "***(I)t is established in Oregon that unexpected difficulties and expense do not excuse performance of a contract unless so extreme that a practical impossibility exists and resulting in a hardship so extreme as to be outside any

(continued...)

Furthermore, to the extent that respondents' argue that the "asymmetry"[41] of the PERS system caused the increase in employer rates, the argument fails due to a lack of proof. The most telling example to illustrate this point is the significant increase in rates for the Oregon judges plan–a "symmetrical" plan–which exceeded the increase in PERS, increasing from 11.54 percent of pay roll to 19.39 percent of payroll. JER-241. In addition, the PERS actuary testified that pension plans throughout the country–presumably, both symmetrical as well as asymmetrical–experienced substantial increases in contribution rates due to the impact of adverse market performance. Tr. Vol. 2 207. That the increase in PERS contribution rates was also due to adverse market performance is supported by both the testimony of the PERS actuary (Tr. Vol. 2 204), and his January 2003 analysis of the funded status of PERS, in which he expressly explained that, "the investment losses for the three years 2000, 2001, and 2002 add up to $13.6 billion. Therefore, from an actuarial standpoint, the major source of the current Unfunded Actuarial Liability is quite clearly recent investment performance." JER-173 (emphasis added).

Similarly, the argument that the "asymmetry" of the system will somehow cause the new higher rates to be locked-in, even in the event of good market returns is without support. This can be illustrated by a review of Exhibit 74 (JER-224), which the PERS actuary testified was a monthly review of the funded status of the plan provided to the legislature during the 2003 session. Tr. Vol. 2 59-63. The analysis shows that in the four month period between March and July of 2003, projected employer contribution rates dropped from 23.4 percent to

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[40](...continued)
reasonable contemplation of the parties,***."

[41]Asymmetry refers to the complex allocation of the risks and rewards of market performance within the PERS system in contrast to a traditional defined benefit plan (such as full formula) which allocates all risks and rewards to employers in a symmetrical fashion.

20.9 percent with an increase in the funded status of the plan on a fair market value of assets basis from 65.8 percent to 74.9 percent. The PERS actuary did not continue these calculations through the remainder of the year though he indicated that good market returns in the latter part of the year would contribute to this downward trend in rates and upward trend in funded status. Tr. Vol. 2 64.[42] Despite asymmetry, therefore, it is apparent that strong market returns will have a strong beneficial impact on employer rates.

Finally, to the extent the system is arguably asymmetrical, this eventuality arises from the basic provisions of the PERS contract. Given the basic structure of PERS, the risk of "asymmetry" was expressly assumed by the respondents. See, *Savage, supra,* 249 Or at 152-153; *Restatement*, Chapter 11, Introductory Note, at 311; § 261, comment b at 314, Illustration 2, at 314. This defense is inapplicable.

b. Frustration of Purpose.

Frustration of purpose is a somewhat related concept for discharge of one's obligations under a contract. It provides that:

> "(w)here the assumed possibility of a desired object or effect to be attained by either party to a contract forms the basis on which both parties enter into it, and this object or effect is or surely will be frustrated, a promisor who is without fault in causing the frustration, and who is harmed thereby, is discharged from the duty of performing the promise unless a contrary intention appears."

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[42]Judge Brewer expressed some concern about the conclusions to be drawn from exhibit 74. He pointed out that some employers had made lump sum contributions to the plan and that in the actuarial valuation of assets, not all losses had as yet been recognized. While both statements are true they have no impact on the conclusions to be drawn from exhibit 74. The information quoted above is taken from the market value analysis which has recognized all losses and Mark Johnson testified that the only monthly changes are based on investment experience. Tr. Vol. 2 59-60.

Tindula v. Bauman, 271 Or 383, 385, 532 P2d 785 (1975), *citing* 1 *Restatement of Contracts*, § 288 (Now *Restatement (Second) of Contracts*, § 265[43]). A promisor seeking to excuse himself from performance must demonstrate that the risk of the frustrating event was "***not reasonably foreseeable and that the value of counter-performance is totally or nearly totally destroyed***." *Smith Tug and Barge Co. v. Columbia Pacific Towing Corp,* 250 Or 612, 643-644, 443 P2d 205 (1968). Foreseeability is important because "***the purpose of a contract is to place the risks of performance upon the promisor" unless it can "***be fairly inferred that the risk of the event that has supervened to cause the alleged frustration was not reasonably foreseeable." *Id.* If the risk was foreseeable then it could have been specifically provided for in the contract. An absence of such provision gives rise to an inference that the risk was assumed. *Id.*

Frustration of purpose is different from impracticability because there may be no impediment to performance. Instead, the intervening problem is such that it "***makes one party's performance virtually worthless to the other, frustrating his purpose in making the contract." *Restatement* at § 265, comment a, at 335. The purpose that is frustrated must have been a "principal purpose" of the party making the contract, meaning that without it, the transaction would have made little sense. The frustration must also be "substantial", requiring more than evidence that the bargain may now be less profitable to the affected party. Indeed, even if the affected party will have to perform at a loss, his obligation is still

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[43] *Restatement* at § 265 reads as follows:

"Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties are discharged, unless the language of the contract or the circumstances indicate to the contrary."

not excused. Finally, the non-occurrence of the frustrating event must have been a basic assumption on which the contract was made. *Id.*

Illustrations under the Restatement include the following:

> "1. A and B make a contract under which B is to pay A $1,000 and is to have the use of A's window on January 10 to view a parade that has been scheduled for that day. Because of the illness of an important official, the parade is cancelled. B refuses to use the window or pay the $1,000. B's duty to pay $1,000 is discharged, ***.
>
> 6. A leases a gasoline station to B. A change in traffic regulations so reduces B's business that he is unable to operate the station except at a substantial loss. B refuses to make further payments of rent. If B can still operate the station, even tough at such a loss, his principal purpose of operating a gas station is not substantially frustrated. B's duty to pay rent is not discharged***."

Restatement at § 265, Illustrations at 335-336.

It is apparent that the contract in this case has not been frustrated so as to excuse performance. The basic purpose of the agreement is to provide retirement benefits for the respondents' employees. Although respondents contend that the retirement benefits received by PERS participants are unduly generous, in fact, the system has never been structured to limit the amount of benefit provided.[44] While the PERS Board set goals and minimum benefit goals (JER-29), from time to time, there is no evidence that the legislature empowered PERS to reach any specific benefit goal. This purpose has not been frustrated by any intervening causes, although its costs may have increased. In addition, the market fluctuations that have contributed to any added expense were certainly foreseeable, and implicitly assumed by the respondents. Also, to the extent that the "asymmetry" of the system is a problem, this was entirely foreseeable and any risk was specifically provided for

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[44] Defendants could have limited the contributions made to member accounts, or the maximum retirement benefits available, but this was not done. Both employer and employee were free to gamble on the equity market.

by the guarantee of an 8 percent return. Finally, any action by the PERB[45] was similarly foreseeable and, to the extent that it affected overall costs, such costs are not a significant part of the overall shortfall.[46]. Defendants can not avail themselves of this defense.

B. The Decision in the *City of Eugene* Case Does Not Justify the 2003 Legislation.

Respondents also raise as a defense the *City of Eugene v. State of Oregon* case, Marion Circuit Court Consolidated Case No. 99C12794. In that case, the Marion County Circuit Court, the Honorable Paul Lipscomb presiding, found, among other things, that PERB acted imprudently in crediting earnings to member accounts and reserves for the 1999 earnings year. Ex. 601. He remanded the matter to the PERS Board to issue new employer rate orders for 1998 and 2000, and a new earnings allocation order for the 1999 investment year. *Id.* With regard to the new 1999 earnings allocation order, he required the Board to fund the gain/loss reserve at its stated 30-month funding goal or provide an explanation for why it had not done so. *Id.* And, finally, he required the Board to maintain a contingency reserve. *Id.*

In his recommended findings of fact, the Special Master found that it was reasonable for the Board to fund the gain-loss reserve at 24 to 36 months, and therefore recommended that its to do so, at that level, was "unreasonable and imprudent." JER-56. The Special Master did not make any recommendations regarding the other conduct by PERB that was found by Judge Lipscomb to be imprudent.

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[45] Respondents also contend that actions of PERB were "ultra vires", thus discharging their obligations. This argument does not constitute a defense. Indeed, to the extent that the actions of PERB are relevant, it may only be to support Defendants' argument that they were not at fault for any existing shortfalls.

[46] The Special Master was unable to make any specific findings concerning the overall cost of any alleged negligence on the part of PERB. JER-56-57.

The precise nature of respondents' *City of Eugene* arguments are not yet clear. But suffice it to say that, to the extent respondents intend to argue that portions of the legislation were justified to remedy errors by PERB, there are several reasons why they are incorrect (and why the Special Master's recommendation regarding the failure to fund the gain-loss reserve should not be adopted by this court).

First, an appeal remains pending before this court from the *City of Eugene* decision. *See City of Eugene v. State of Oregon, et al*, Supreme Court of the State of Oregon Case No. S50617. While the local government entities, the state, and PERB apparently have settled the dispute between them, the intervenors – various PERS members – also appealed from Judge Lipscomb's judgment. The intervenors already filed their opening brief and are proceeding with their appeal. Among other things, they challenge as error Judge Lipscomb's rulings regarding PERB's alleged imprudence.[47]

To the extent Judge Lipscomb's rulings in the *City of Eugene* litigation have a bearing on the validity of the 2003 legislation, this matter is inextricably intertwined with the pending *City of Eugene* appeal. The same arguments made by intervenors in that case as to why PERB's conduct was not imprudent apply equally here. Thus, petitioners adopt the arguments made by intervenors in the *City of Eugene* appeal. Petitioners also provide the following additional arguments as to why PERB did not act imprudently in crediting earnings in 1999, and as to why this court should not engage in 20/20 hindsight second-guessing with

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[47]It is ironic and somewhat disturbing that, although PERB and the state of Oregon were adverse to the local government employers in the *City of Eugene* case, and adamantly defended PERB's practices in that case, PERB and the state of Oregon have joined forces with local government employers in the present case and have defended the 2003 legislation in part based upon PERB's alleged misconduct.

respect to PERB's administration of what no one disputes is an extremely complex retirement benefits system.

Two legal principles form the context under which this court should address PERB's purported imprudent conduct. First, the legislature long ago declared PERS to be a trust. ORS 238.660(1). Second, under basic tenets of the common law of trusts, whether a trustee's conduct is unreasonable or imprudent is to viewed from the circumstances existing at the time the decision in question was made. *Restatement (Second) of Trusts* §174 comment b (1959)[48]. It is improper for courts to apply 20/20 hindsight to second-guess the trustee's decision, or to substitute the court's judgment for that of the trustee. *Id.*; *see also Restatement* at §187. This is particularly true where the trustee has been given discretion in carrying out its duties and powers. *Id.*

The circumstances as they existed in early 2000 show why PERB did not abuse its discretion in crediting reserves and earnings. In the two decades prior to 1999, there had never been a deficit in the gain-loss reserve. During that time frame, PERS had maintained funding goals for the gain-loss reserve of either 18 months without earnings or 24 months without earnings. Just before PERB decided to adopt a 30-month goal for funding the gain-loss reserve, the goal had been set at 18 months. Tr. Vol. 1 152-53. PERB adopted the 30-month goal during the same time frame when it was making the 1999 earnings crediting decision, and did so in response to a study performed by the Frank Russell Company at the

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[48] Comment b, expressly states that:

> "*b. Test of prudence.* Whether the trustee is prudent in the doing of an act depends upon the circumstances as they reasonably appear to him at the time when he does the act and not at some subsequent time when his conduct is called in question."

request of the Oregon Investment Council which concluded that a 30-month goal would be better for the long-term stability of the fund. Tr. Vol. 1 153-54.

Objectively, in early 2000, PERS appeared to be in good shape by historic standards. Between 1975 and 1999, the funded ratio for PERS ranged from a low of 59 percent in 1975 to a high of 101 percent in 1989. JER-239. According to the actuarial valuation provided by the PERS actuary, the funded ratio of PERS in 1999 was 98 percent. Moreover, employer contribution rates were stable in the late 1990s. From 1995 to 1997, the average employer contribution rate increased by 1.98 percent, from 9.42 percent to 11.40 percent. However, there is no dispute that the passage of HB 3349 by the 1995 legislature, which addressed compensation for taxation of PERS benefits, accounted for 1.4 percent of the employer rate increase. JER-41.

Then, in 1999, the average employer contribution rates decreased again by 0.66 percent to 10.74 percent. From 1975 to 1999, the average employer contribution rate ranged from a low of 9.15 percent in 1993 to a high of 11.87 percent in 1977. Thus, employer contribution rates for 1999 remained solidly in the middle of that range.

In early 2000, PERB considered, among other things, how to credit earnings for 1999. The PERS fund had enjoyed several consecutive years of large growth, and there was nothing to indicate that things were about to change. The Board made a preliminary decision to credit 1.3 billion dollars to the gain-loss reserve and 6.2 billion dollars to other accounts, including Tier One member and employer accounts. JER-31. PERB presented its preliminary decision to the legislature as it was required to do. It heard comments from PERS members and employers regarding both the proposal to extend the gain-loss reserve, and the proposal for

crediting earnings and, as one would expect, the comments were far from consistent. JER-164-169.

In February 2000, the PERS staff presented the Board with a matrix of 30 different options for the final 1999 earnings crediting decision. PERB ultimately selected the option which would distribute earnings of 20 percent to Tier One member accounts, benefits-in-force reserves, and employer accounts. The rest was distributed to the gain-loss reserve, resulting in a balance of approximately $4.8 billion. The balance in the gain-loss reserve was enough to cover nearly 23 months of the Tier One guarantee assuming zero earnings on the fund assets. This was well in excess of the previously-held 18-month goal, but did not fully fund the newly-adopted 30-month goal.[49]

Bearing in mind the favorable circumstances that PERB encountered in early 2000, and the fact that PERB was required by statute to administer PERS as a trust for the benefit of the PERS members, there is no basis to conclude that PERB's earnings crediting decision was unreasonable and imprudent. It is only with the benefit of hindsight that one could reasonably question PERB's conduct. But, as noted, using such hindsight to second guess PERB's decision is improper. This court should refuse any invitation by defendants to substitute the court's judgment for that of PERB, and should thus find that there is nothing unreasonable and imprudent about PERB's 1999 earnings crediting decisions.

VII. CONCLUSION.

For the foregoing reasons, Sections 1, 3, 5, 6, 7, 8, 9, 10, 14b(1)(a)&(b)&(2) of HB 2003 and section 4 of HB 2004, as amended by HB 3020, violate Article I, Sections 21 and

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[49]This decision to fund the increase of the gain/loss incrementally was consistent with past board practice. Tr. Vol. 2 232-233.

18, of the Oregon Constitution and breach petitioners PERS contracts.[50] This court should declare these sections void as applied to petitioners and enjoin application of these sections to petitioners' PERS contracts.

DATED this 17th day of May, 2004.

Respectfully submitted,

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[50]Petitioners, as well as thousands of other PERS participants, have made career decisions based on this court's decisions over a 60 year period which protect the contract rights of public employees to receive the benefit of their pension promise.

CERTIFICATE OF FILING AND SERVICE

I hereby certify that I filed the original and 15 copies of the STRUNK PETITIONERS' OPENING BRIEF by regular first class mail on the following:

State Court Administrator
Records Section
Supreme Court Building
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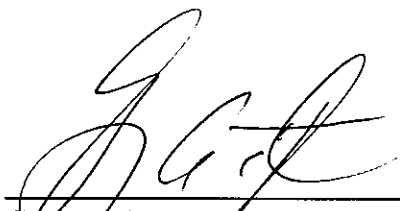
DATED this 17th day of May, 2004.



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