

GARY NAUTA, and ROGER GARVER,
Intervenors.

CITY OF EUGENE, a municipal corporation,
by and through Eugene Water & Electric Board,

Petitioner,

v.

STATE OF OREGON, PUBLIC EMPLOYEES
RETIREMENT BOARD,

Respondent/Defendants,

and

KAREN JENKINS, DIANE DAVIDSON,
ARLYN STEPPER, GARY GILLESPIE,
ANN MONTAGUE, JUDITH ANN SUGNET,
GARY NAUTA, and ROGER GARVER,

Intervenors.

Case No. 99C20235

ROGUE RIVER VALLEY IRRIGATION
DISTRICT, a municipal corporation,

Petitioner,

v.

STATE OF OREGON, PUBLIC
EMPLOYEES RETIREMENT BOARD,

Respondent/Defendants.

Case No. 00C16173

OPINION AND ORDER

Introduction

These consolidated cases are pending before this Court upon Petitions for Judicial Review of several Orders of the Defendant Public Employees Retirement Board (Board). The

cases were filed by the petitioning employers¹ seeking review of the 1998 and 2000 employer contribution rate orders for each of them, as well as for review of the Board's March 2000 earnings allocation order. The Intervenors are public employees who also seek judicial review of the Board's March 2000 earnings allocation order.

Essentially the petitioning employers contend that their contribution rate orders for 1998 and 2000 were set at an improperly high level as a result of the Board's failure to follow various statutory directives of the legislature in administering PERS. They also contend that the 2000 earnings allocation order (distributing the 1999 earnings of the Fund) constitutes an improper abuse of the Board's administrative discretion in several respects.

The Intervenors, in turn, contend that the Board's 2000 earnings allocation order was an improper breach of its fiduciary duties to the participating employees, as well as a breach of contract, in that a portion of the 1999 Variable Fund earnings were allocated to employers who had not participated in the Variable in 1999.

This Court previously issued an Order of Partial Summary Judgment in July of 2001 disposing of some of the claims in these cases, and thereafter a trial on the merits was held on the

¹ The petitioning employers are the City of Eugene, Lane County, Multnomah County, City of Portland, City of Roseburg, City of Huntington, Canby Utility Board, and Rogue River Valley Irrigation District. They represent a cross section of some of the largest, and some of the smallest public employers participating in PERS. Most participating employers, however, are not parties to these lawsuits.

remaining claims. The parties have just recently concluded their post-trial briefings and the record in these cases is now closed. This opinion will serve as the final decision of this Court.

At the outset it should be clearly noted that there appears to be nothing fundamentally wrong with the current statutory system for the retirement of public employees. The basic structure of PERS is sound, and indeed, strong. The system should be susceptible to careful and prudent administration by the Board without undue difficulty. Working through the interplay of various statutory sections can be cumbersome at times because of the number of legislative amendments made over the past 50 years. Moreover, portions of the statutory language employed by the legislature seem unnecessarily obscure in some sections.² Yet overall, PERS remains a well designed and seemingly resilient system which has for many years served both the public employees and the public employers of this state very well. Properly administered, there is no reason why the current system cannot continue to operate successfully, and continue to benefit all concerned.

Notably, none of the petitioning employers have argued that there are any unmanageable problems with the statutory structure of the current PERS system as crafted by the legislature.

² See, e.g., ORS 238.670 (2) [1999 version]:

“At the close of each calendar year, the board shall set aside, out of interest and other income received during the calendar year, after deducting the amounts provided by law and to the extent that such income is available, a sufficient amount to credit to the reserves for pension accounts and annuities varying percentage amounts adopted by the board as a result of periodic actuarial investigations. If total income available for distribution exceeds those percentages of the total accumulated contributions of employees and employers, the reserves for pensions and annuities shall participate in such excess.”

Rather, the complaints of the petitioning employers all relate to claims of mismanagement and abuse of administrative discretion by the Public Employees Retirement Board. The Board is the administrative agency charged with the operation and management of the system by the legislature.³

Unfortunately, it is the conclusion of this Court that many of the complaints raised in these cases are well founded. As a direct result of the Board's improper management of PERS, particularly in recent years, there have been funding shortfalls which should not have occurred if the Board had been faithful to its duties under the statutes. These funding shortfalls have resulted in employer contribution rate orders which have been ratcheted up to levels which are disproportionately higher than they otherwise would be for the petitioning employers. The Board's 2000 earnings allocation order is also inconsistent with the legislature's mandates in several respects, as has been demonstrated by both petitioning employers and the intervening employees in this case. Accordingly, all challenged orders shall be reversed and these cases will be remanded to the Board to correct the various legal errors and several abuses of discretion in administering the fund as are set forth below in more detail.

THE RATE ORDER APPEALS

³ The Board is composed of eleven individuals appointed by the Governor and confirmed by the Senate. ORS 238.630. See also ORS 238.640.

Pursuant to their First through Third and their Sixth Claims for Relief, the petitioning employers raise ten separate issues, all of which are alleged to have increased their employer contribution rates in 1998 and 2000 to cover funding shortfalls and unfunded liabilities. Many of the claims with respect to the 1998 orders relate back to prior years' earnings allocation orders which have not been challenged in a timely fashion.⁴ Those earlier earning allocation orders may not now be indirectly attacked through challenges to subsequent employer contribution rate orders.⁵ However, these same complaints have been reiterated in Petitioners' Fourth Claim for Relief which timely challenges the Board's March 27, 2000 earnings allocation order, and will be later addressed in this decision in connection with that order. To the extent that the petitioners' challenges to their 2000 employer rate contribution relate to the March 2000 earnings allocation order, they are more appropriately addressed in that section of this opinion. (Those issues on which the employers prevail as to the March 2000 earnings allocation order should naturally result in an appropriate adjustment in their 2000 rate contribution orders as well.) The remaining claims with respect to the 1998 and 2000 employer contribution orders are now addressed as follows.

⁴ For example, Count One of Petitioners' First Claim for Relief challenges the Board's failure to fund and use the contingency reserve. Count Three contests the Board's failure to use its discretion to allocate differing percentages of earnings to account for different liabilities and deficits in various statutory accounts. Count Eight challenges the Board's ongoing practice of crediting unrealized investment gains to employee accounts in excess of actual realized income received of fund investments. Count Nine relates to the Board's alleged practice of crediting the Benefits in Force Reserve less than the necessary amounts to meet the needs of that reserve. Finally, Count Ten contests the Board's practice of crediting Tier 1 employee regular annuity accounts in amounts of excess of the assumed interest rate while failing to adequately fund the statutory reserve accounts.

⁵ See *Teel Irrigation Dist. v. Water Resources*, 323 Or 663, 919 P2d 1172 (1996); *Carnine v. Oregon State Textbook Comm.*, 62 Or App 344, 660 P2d 201, rev denied, 295 Or 259 (1983).

The Money Match on Variable Earnings Issue

Count Two challenges the Board's actions in requiring the petitioning employers to match the earnings in their employees' variable annuity accounts at the time of the employees' retirement. These employers contend that this practice is inconsistent with ORS 238.260 (12) and has required them to pay much larger contributions to the Fund than would be necessary to fund the statutorily authorized pensions and has increased their unfunded liabilities.

For the reasons set forth at pages 7 through 15 of this Court's prior opinion on Summary Judgment, these employers are correct, and they are entitled to an order reversing the challenged employer rate orders with directions to the Board to recalculate the employers' contributions in accordance with the orders of this Court.⁶ The Variable Account adjustment to the members' service retirement allowance under ORS 238.260 (12) is to be applied after, and not before, the calculation of the members' service retirement allowance pursuant to ORS 238.300, whether or not the so-called "Money Match" retirement option is applied under subsection (2)(b) of that statute.⁷

⁶ A copy of this Court's earlier opinion is attached hereto and made part of this decision and order.

⁷ In addition, upon further investigation, analysis, and consideration, it now appears that the only previously noted potential impediment to implementation of this Court's earlier construction of ORS 238.260 (14) is not really an impediment at all. In Footnote 9 of its earlier Summary Judgment opinion, the Court noted Intervenors' argument that ORS 238.260 (14) would appear to allow retirees to circumvent ORS 238.260 (12) by transferring their variable account balances to their regular accounts shortly before retiring. That premise was then accepted without critical examination, but it was found to be immaterial to the court's ultimate decision. Upon further analysis, however, it does not appear that such transfers could have that effect.

Both subsections (12) and (14) are part of the same statute and must be read together. Subsection (14)(f) provides that the annuity of a member, who makes a transfer of funds from their variable account to their regular account shall be based on the member's account balance "as otherwise provided in this chapter," including, notably, ORS 238.300. ORS 238.300 (2)(a) provides that for variable participants, their refund annuity is provided "on the same basis" as if they had been in the regular account all along. Subsection (12) of ORS 238.260 then provides that "notwithstanding any other provision of this chapter," the retirement allowance calculated under ORS 238.300 for members who maintain a variable account "shall be subject to the following adjustment." The adjustment compares the "total account of the member . . . and what the total account of the member would have been had the member not participated in the variable annuity program." The ORS 238.300 retirement allowance is then adjusted up or down according to the relative performance of the variable. Since the mandatory subsection (12) adjustment is based on the difference between what the "total account" of the member is and what that "total account" would have been had the member not participated in the variable, it would appear to make no difference whether the member were still in the variable or had earlier elected an ORS 238.260 (14) transfer.

The Board objects that subsection (12) only applies to a member "who has an account in the Variable Annuity Account," and argues that after a subsection (14) transfer the member no longer has such an account. Subsection (14) transfers do not necessarily close the members' variable accounts, however. The statute simply specifies that the member may transfer the balance in that account to their regular account. Thereafter an inactive account may still exist, albeit with a zero balance. Moreover, if the construction of the statute were otherwise, an equally anomalous situation would obtain. Those members who transferred their variable balances to their regular accounts under subsection (14) shortly before retiring would get a doubled employer match, and those who transferred the balance under subsection (9) shortly after retiring would not.

Finally, subsection (14) was not adopted until 1991. Subsection (12) was brought into the statutory scheme in 1981. Plainly, the 1991 amendment cannot tell us anything about the legislative intent during the 1981 session.

It is not immediately plain from the words of this statute itself that the “annuity provided by the accumulated contributions of the member” in subsection (2)(b) necessarily refers to the annuity prior to the variable adjustment. Indeed, from 1969 until 1981, when the subsection (12) adjustment was added to the variable statute, the potential employer “match” would apparently have applied to the full amount of all annuity accounts. Nevertheless, once (12) was adopted in 1981, there is no apparent reason not to give it full effect in accordance with its terms: “not withstanding any other provision of this chapter.” See ORS 238.260 (12).

This kind of preemptive statutory language is essentially a legislative mandate to the courts to force fit, if necessary, the new provision into the existing legislative scheme. While such a directive is not a good substitute for thoughtful and careful legislative craftsmanship, and clear communication of the amendment’s intended purpose and effect, its plain import cannot be simply ignored.⁸

⁸ See ORS 174.010:

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

Like subsection (12) of ORS 238.260, ORS 238.300 (2)(b) also contains a “force fit if necessary” clause directing that it is to be applied “notwithstanding” any other provision of this chapter. Subsection (2)(b) then mandates that in calculating the employer pension, the Board must ensure that it is at least equal to the employee’s annuity calculated under subsection (2)(a). Before, of course, one can determine whether it is necessary to resort to subsection (2)(b)’s doubling provision to establish the ultimate size of the employer pension, that pension must first be calculated in the normal fashion provided in ORS 238.300 (2)(a). Only after applying subsection (2)(a) can the overriding provisions of subsection (2)(b) come into effect to make sure that the resulting employer pension is at least the actuarial equivalent of the employee annuity as calculated pursuant to the ORS 238.300 (2)(a) criteria.

The only way to give effect to both the mandatory language of subsection (12) of ORS 238.260 and the mandatory provision of ORS 238.300 (2)(b) is to treat the language of 238.300 (2)(a) stating that the variable account annuity is to be provided “on the same basis” as the employees’ regular account annuity as requiring that the variable annuity be initially calculated as if it had actually been held in the regular account. Once the variable annuity is calculated “on the same basis” as the regular annuity, the employer pension is then determined, initially, in accordance with ORS 238.300 (2)(a). Next, the potential matching provision of ORS 238.300 (2)(b) is applied to determine the final amount of the employers’ pension. Only then is the employee annuity adjusted in accordance with the variable adjustment provisions of subsection (12) of ORS 238.260.

This Court’s construction of the interplay of those statutes is entirely consistent with the way PERS represented to the legislature that these two provisions would work at the time

subsection (12) of ORS 238.260 was adopted. The legislature was clearly told that the variable annuity was to be calculated initially as if it had been held “on the same basis” as the regular annuity account. In explaining the operation of the proposed amendments to the Senate Committee on Insurance, Banking and Retirement on February 6, 1981, PERS’ independent consulting actuary, Paul C. Hart, explained that switching to the full formula as the principal retirement vehicle would still “protect” employees participating in the variable by essentially creating a phantom regular account for them.

“PERS would actually maintain two accounts for them. One would be the actual variable account and the other would be what their account would have been if they had been in the regular general account of the system rather than the variable. At retirement, then, their full benefit would be either reduced or increased by either the excess investment earnings out of the variable or the rate by which the variable didn’t match the general account. So there would still be the opportunity for the employee to get the same differential out of the variable that he or she can get out of the existing law.”

This is also consistent with the Board’s actual practice in calculating the effect of ORS 238.260 (12)’s variable adjustment on the “full formula” service retirement allowance option:

“This adjustment is based on a comparison of the member’s variable account as if he/she had never been in the variable to the actual variable account. The variable at variable rate is compared to the variable at the regular rate.”

(Affidavit of Jacqueline P. Reep, Processing and Data Quality Division Administration for

PERS, Exhibit 1, page 1.)

Of course, these statutes neither provide for, nor allow, inconsistent treatment of the interplay of these statutory subsections depending on which retirement option is being calculated. Rather, each retirement option must be calculated under a consistent interpretation of the same statutory language.

On remand, the Board must adjust the applicable rate orders of these employers, in accordance with the correct application of these statutes as determined by the court.

The Exclusive Benefit Issue

Count Four of the employers' First Cause of Action challenges the Board's use of fund assets to compensate retirees whose pensions had been illegally taxed by the legislature in prior years. The employers argue that use of PERS funds for that purpose violates the federal "exclusive benefit" rule which has been impliedly incorporated into the PERS statutory scheme by ORS 238.630 (3)(h).

On this issue, this Court previously determined upon Summary Judgment that the employers are wrong. See pages 19-20 of the prior opinion. Additionally, use of PERS funds for this purpose would not appear to violate ORS 238.630 (3)(h) under any circumstances as the affected retirees are beneficiaries of the fund. Moreover, in ORS 238.375 the legislature explicitly required the Board to distribute such "increased benefits" "notwithstanding any other provision of law". Accordingly, there can be no statutory violation of ORS 238.630 (3)(h) by the Board's implementation of ORS 238.375.

The Use of the Gain-Loss Reserve to Benefit Employers Issue

Count Five challenges the Board's failure to exercise its alleged authority under ORS 238.670 (2) to use the Gain-Loss Reserve to augment employer pension accounts to offset recent extraordinary gains in employee annuity accounts rather than to require employers to make further increased contributions. The petitioning employers are incorrect. Nothing in ORS 238.670 (2) appears to contemplate the kind of discretionary authority suggested by these employers in this instance.

The Unfunded Mandates Issue

Count Six contends that various Board actions allegedly increased retirement allowances for employees beyond those required by Chapter 238, and that this constitutes an "unfunded mandate" forbidden by Art. XI, § 15 of the Oregon Constitution. This issue was determined adversely to the employers upon Summary Judgment. In addition to the conclusions there reached, it should also be noted that there could be no violation of Section 15 of Art. XI in any event because PERS would qualify for a subsection (7)(c) exemption as "an existing program as enacted by legislation prior to January 1, 1997," even if this claim were otherwise correct.

The Outdated Mortality Tables Issue

Count Seven challenges the Board's use of inaccurate and outdated mortality tables. These employers argue that the Board's continued use of outdated mortality factors and its adoption of OAR 459-005-0055 (1993) has resulted in higher retirement benefits than would

result from the use of more accurate, updated mortality factors and also correspondingly higher employer contributions. This argument is well taken.

ORS 238.300 (1) specifies that the refund annuity portion of the service retirement allowance “shall be the actuarial equivalent” of the members’ contributions and the interest thereon. Subsection (2)(b) similarly specifies that the other portion of the service retirement allowance, the employers’ pension, shall be at least the “actuarial equivalent” of the annuity provided by the contributions of the member. ORS 238.630 (3)(g) directs the Board to determine the “actuarial equivalency” of optional forms of retirement allowances and to “establish from time to time for that purpose the necessary actuarial factors, which shall constitute a part of the system”.⁹ In practice, and in accordance with this statutory procedure, the PERS actuary studies current mortality factors and reports back to the Board.¹⁰

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

⁹ The Board has apparently always construed the term “actuarial equivalency” to mean actual parity, at least with respect to the application of the so called “Money Match” provision of ORS 238.300 (2)(b).

¹⁰ ORS 238.605 directs the Board to employ a “competent actuary” to evaluate the mortality of members and make appropriate recommendations.

The actual practice of the Board has not been faithful to this legislative mandate for some time. Rather, the Board has maintained its reliance on mortality tables dating back to 1978 despite consistent evidence that members' mortality was gradually improving and that, as a result of retired members living longer, the retirement benefits of new retirees would need to be reduced in order to maintain "actuarial equivalency." This reliance on the 1978 tables has continued despite periodic recommendations from the Board's own actuary to adopt more modern mortality tables. Indeed, in 1993 the Board went so far as to promulgate an administrative rule stating that the Board would not adopt more current mortality tables unless doing so would produce a higher monthly benefit for members. See OAR 459-005-0055.

It is the conclusion of this Court that the Board has acted improperly in refusing to update its mortality tables and has abused its discretion in failing to follow the legislative mandate to maintain "actuarial equivalency" when determining retirement benefits. None of the justifications and rationalizations offered by the Board are sufficient to excuse the Board's persistent refusal to implement this part of the statutory scheme except when it would benefit employee members. Neither fear of litigation by employees, nor a concern for a potential challenge by the Internal Revenue Service is a sufficient basis for ignoring the Board's own statutory obligations as established by the legislature.¹¹

¹¹ The Board, of course, could have gone to the legislature seeking an amendment to these statutes to resolve the issue if it felt that either of these concerns were so substantial that a statutory fix was necessary. In any event, neither concern appears particularly substantial. Employees are only entitled to the benefits provided by statute, and the statute itself requires periodic revisions of benefits to maintain actuarial equivalency. IRS regulations appear to relate only to defined benefit plans and the defined benefit portion of this plan, the "full formula" option, is apparently unaffected by changes in mortality; the employee simply receives the full statutory benefits for the full length of their life.

Although the Board has just recently adopted a new policy to implement updated actuarial equivalency factors as of January 1, 2004, this new policy offers too little, too late. The old policy clearly does not accord with the statutory mandate, but it would still be continued in effect until December 31, 2003 under the Board's new policy. Moreover, the Board has chosen to guarantee that even thereafter employees' benefits will still never dip below the amount which would have obtained under the old mortality policy while it was in effect. Neither proposed practice is permissible under the law. The Board has a duty to comply with the statutory mandate immediately and fully.

Nor can the Board fairly charge the petitioning employers for increased contributions caused by the Board's failure to implement the recommendations of its own actuary to maintain "actuarial equivalency" in the intervening time frame. These petitioning employers are entitled to have their challenged 1998 and 2000 contribution rate orders recalculated by the Board in a manner consistent with the Board's duty to maintain the "actuarial equivalency" of benefits through the use of current mortality factors as previously recommended by their own actuary and as required by statute.

THE MARCH 2000 EARNINGS ALLOCATION ORDER APPEAL

Petitioners' Fourth Claim for Relief seeks judicial review of the Board's March 27, 2000 earnings allocation order. That order allocates 1999 earnings among the various accounts in PERS.

The Authority of the Board to Discriminate Between Funds

Count One of this Claim asks this Court to mandate that the Board exercise its discretion to allocate the 1999 earnings in varying percentages among the different funds maintained in PERS “to coordinate the growth in the accounts with the growth in account liabilities and to balance any fund deficits.” Essentially, the employers are alleging that the Board has misinterpreted ORS 238.670 (2) as a restriction on its authority to discriminate between the several accounts maintained within PERS on the basis of their relative needs.

The language of ORS 238.670 (2) is far from a model of clarity.¹² Indeed, it is difficult to decipher with any degree of certainty what exactly was intended by the legislature with respect to each particular of that statute. Nevertheless, it is clear that the statute does not contain any explicit restriction on the Board’s overall discretion to manage the system in accordance with ORS 238.630 (2), and with the overall goals and objectives of the system. See ORS 238.635. See also ORS 238.601.

Nor is there any implied restriction on the Board’s overall discretion contained in ORS 238.670. On the contrary, the apparent purpose of that statute is to increase the flexibility and stability of the system in order to allow the Fund to respond to any unforeseen eventualities and to adjust to the periodic fluctuations of its investments. There is no implied requirement that such responses be administered in a blanket, across the board fashion.

Although this Court does find that the Board has discretion to respond to the apparent relative needs of each of its accounts with varying allocations of the available earnings of the Fund, in this case, there has been insufficient proof that the petitioning employers have been

¹² ORS 238.670 (2) is quoted in its entirety at Footnote 2 above.

materially harmed by the Board's failure to fully exercise its discretion in this area to date. However, in exercising its discretion in accordance with the reallocation of the 1999 earnings upon remand on the other issues in this case, the Board should not feel constrained from discriminating among the various accounts on the basis of relative need. That authority plainly exists and it should be exercised when appropriate.

The Failure to Fund and Use the Contingency Reserve

Count Two of the Employers' Fourth Claim challenges the Board's failure to fund and use the Contingency Reserve. This issue has already been determined in Petitioners' favor on Summary Judgment.¹³ As this Court has already said, ORS 238.670 (1) mandates that a reserve account to cover unforeseen contingencies "shall be maintained and used by the board to prevent any deficit of moneys available for the payment of retirement allowances" This language is neither discretionary nor ambiguous. The Board's persistent failure to follow this statute is improper. While the Board maintains a range of discretion in determining how much of the earnings to allocate each year to the Contingency Reserve, it has no discretion to simply ignore the legislature's specific direction that this account "shall be maintained and used to prevent any deficit."

By ignoring its obligation to fund and maintain the Contingency Reserve in place, the Board has improperly impaired the overall resiliency and flexibility of the entire PERS system and has forced the system to rely almost exclusively on periodic increases to the employers' contribution obligations in order to keep its accounts in balance. In doing so, the Board

¹³ See pages 16-19 of this Court's earlier decision, a copy of which is attached.

threatens to gradually, but inevitably, kill the proverbial goose that lays the golden eggs. The Board has been declaring periodic increases in employer contributions at a rate that cannot be sustained indefinitely. While each of these employers is a publicly funded entity, neither these employers, nor the taxpayers, has access to unlimited funds.

Petitioners are therefore entitled to an order remanding the March 2000 Earnings Allocation Order to the Board with instructions to abide strictly with the statutory mandate to fund and maintain a Contingency Reserve in accordance with ORS 238.670 (1). Moreover, because, in part, of the Board's failure to allocate any funds at all to this account for many years, there will be a very heavy burden on the Board upon remand to justify any decision to fund this account at less than the full statutory maximum of 7.5% of the 1999 earnings.

Fully funding the contingency reserve, even at this late date, may also afford the Board more flexibility in responding to this Court's direction to recalculate the so-called Money Match service retirement allowances for retired members who participated in the Variable and to update its mortality tables before recalculating the petitioning employers' 1998 and 2000 contribution rate orders.

The Gain/Loss Reserve

Count Three of the Fourth Claim for Relief relates to much the same issue raised in Count Five of Petitioners' First Claim for Relief. However, with respect to the March 2000 earnings allocation order, this issue has more merit.

While the Board has wide discretion under ORS 238.670 (3) and (4) as to how much, if any, of the earnings from any year are to be allocated to the gain-loss reserve, that discretion is

not boundless. Recently, the Board adopted a policy of maintaining that reserve in an amount sufficient to cover the Tier 1 guaranteed rate for 30 months of losses. Then, in the face of an extraordinary earnings year, the Board inexplicably failed to fund that reserve with enough of the available 1999 earnings to meet that goal, apparently preferring to allocate the remaining earnings to the regular Tier 1 accounts at a rate more than double that guaranteed by statute. The inevitable effect of that aggressive crediting decision was to substantially increase the burden on the Gain/Loss Reserve for covering future earnings shortfalls as required to meet the guaranteed rate of return to those accounts. At the same time, this aggressive earnings allocation has substantially raised the future potential needs of the Gain/Loss Reserve account, particularly if it is ever to be funded at a level that meets the Board's 30 month funding goal.

Why the Board's own articulated 30 month goal for this reserve account was not fully funded when the Board had an excellent opportunity to do so in a record breaking earnings year has never been adequately explained. On remand, if the Board persists in allocating out of the 1999 earnings an amount that is less than sufficient to meet its previously stated goal for the Gain/Loss Reserve account, the Board must make findings sufficient to explain its action so that this Court can adequately review it for an abuse of discretion. See ORS 183.484 (5)(b)(B).

The Unfunded Mandate

Count Four of this Claim raises again the same issues alleged in Count Six of Petitioners' First Claim, and, again, the same analysis is equally applicable here. There is, accordingly, no need for further discussion of that issue at this point.

Crediting Earnings in Excess of Interest and Other Income Received

Count Five alleges that the Board's practice of crediting Fund earnings to employee accounts in excess of "interest and other income received" violates the statutory requirements of ORS 238.670 (2). However, this Court finds that the Board's crediting practices, in this regard, are consistent with its discretion and do not contradict any statutory mandate. Rather, the Board's practice in this instance reflects a well reasoned and long standing interpretation of indefinite statutory language, and it is consistent with the overall legislative policy.

Benefits-in-Force Reserves

Count Six of this Claim alleges that the Board's March 2000 earnings allocation order failed to credit a sufficient amount to the Benefits-in-Force Reserve so that it would contain enough resources to pay ongoing benefits for retired members. Petitioners point out that ORS 238.670 (2) is stated in mandatory terms and requires the Board to fund the Benefits-in-Force Reserve prior to allocating any earnings to any discretionary accounts. The petitioning employers complain that the Board's failure to fully fund all the needs of this reserve has forced the employers to make up the difference.

Specifically, the statute provides that "at the close of each calendar year the board shall set aside . . . a sufficient amount to credit (the Benefits-in-Force Reserve) varying percentage amounts adopted by the board as a result of periodic actuarial investigations." Petitioners contend that this language requires that the Benefits-in-Force Reserve must be "trued up" out of each calendar year's earnings in accordance with the investigations of the Board's actuary. It is only after the full needs of existing retirees have been met that the earnings of any calendar year may be allocated to the accounts of existing employees and their employers. The Board and the Intervenors contend that historically the "varying percentage amounts" language was intended to

refer only to the current earnings assumption, which is presently 8%.

It is apparent from this statute that each year the Board must appropriately credit the Benefits-in-Force Reserve before crediting other accounts. Little else is readily apparent from the statutory language. Accordingly, this Court cannot say, as a matter of law, that the Board has acted erroneously in failing to meet the full needs of the Benefits-in-Force Reserve before crediting other accounts. The wording of the statute supports the employers' view, but the statute's history does not.

This provision cries out for legislative clarification, but until that occurs this Court is able to determine only that the requirements of this statute must be complied with before the other accounts of the system are addressed. Apparently, this has not been the Board's ordinary practice, but it must be. Therefore, upon remand of the March 2000 earnings allocation order, the Board must first comply with ORS 238.670 (2) before allocating the remaining earnings in accordance with its discretionary authority and with the other provisions of this order.

The Tier 1 Employee Allocations

In Count Seven of this Claim the petitioning employers contend that the Board's action in crediting to the regular, non-variable Tier 1 employee accounts an amount more than double the statutorily guaranteed amount constitutes an abuse of discretion.¹⁴

The evidence presented at trial indicated that for much of the excellent earnings years of

¹⁴ The statutorily guaranteed rate is the "assumed interest rate for that year determined by the Board." ORS 238.255. For each year applicable herein, the assumed rate has been 8%. For the 1999 earnings year, the Board credited those Tier 1 accounts at 20%.

the 1990's, the Board practiced a very aggressive crediting policy and actively sought to maximize the percentage of earnings allocated to employee accounts at nearly every discretionary decision point despite the significant, and cumulative, adverse impacts to employers, and despite a gradually increasing danger of de-stabilizing the entire system over time as that practice continued.

The petitioning employers contend that the guaranteed rate should not be significantly exceeded even in strong earnings years. However, the statutory guaranteed rate of return was adopted in 1975 in lieu of a salary increase during an earlier economic downturn. ORS 238.255 was never intended to be a ceiling on earnings allocations, just a floor. At the same time it was not contemplated by the legislature that earnings allocations substantially in excess of the guaranteed rate for the regular employee accounts would become so generous that the incentive for Tier 1 employees to continue in the variable would be impaired. Currently, however, the Board's recent aggressive crediting practices benefitting non-variable Tier 1 accounts is eroding any inducement for employees to participate in the variable in order to capture anticipated higher benefits by tolerating higher risks over time. In good years, the Tier 1 regular accounts have been credited with earnings nearly as high as the variable accounts, and in bad years they are guaranteed not to fall below 8%.¹⁵ This practice is clearly contrary to the legislative policy

¹⁵ The evidence indicated that during the last 10 years the Variable accounts have earned an average of 13.62% and the Regular accounts have averaged 13.03%, a difference of only 0.59%. With the current market downturn, the Regular accounts average rate of return should now easily exceed that of the Variable.

which gave rise to the creation of the Variable in the first place. See ORS 238.260.

The cumulative effect of the Board's practice has been to drive up Tier 1 employee accounts to levels which are likely to be sustainable only at much additional expense to the employers for many years to come. Once allocated to the non-variable Tier 1 accounts, those additional earnings must command additional growth at an annual rate of interest guaranteed at 8% currently. But that 8% rate of return reflects only the anticipated average rate of earnings for the fund over many years. Good earnings years in excess of 8% are anticipated to be eventually offset by poor earnings years of well less than 8%. When earnings are allocated to Tier 1 accounts at rates substantially in excess of 8% during good earnings years at the expense of the Contingency Reserve and the Gain/Loss Reserve, the future demands of further guaranteed earnings rapidly increase. As a result, the stability of the system is gradually eroding for it lacks the necessary flexibility to meet the statutorily guaranteed rate in years of negative earnings without increasing employer contributions more and more substantially. That effect is further exacerbated by the steadily increasing popularity of the "Money Match" retirement option which can double those extra demands on the employers for Tier 1 retirees. As a result, over time, the sustainability of the system itself could eventually be jeopardized.

At some point on the continuum of discretionary decision making, ordinary fiscal imprudence becomes an abuse of discretion. In this Court's judgment, by any reasonable calculation, that point was crossed in this case when the decision was made to allocate more than double the guaranteed rate of return to Tier 1 employees out of the 1999 earnings without fully funding the statutory reserve accounts.

Accordingly, upon remand the Board is directed to exercise its discretion to credit the extraordinary earnings of 1999 in a much less aggressive, and in a much more prudent fashion, in accordance with its statutory obligations as set forth above.

THE FIFTH CLAIM FOR DECLARATORY RELIEF

The Employers' Fifth Claim for Declaratory Relief seeks a Declaratory Judgment in their favor pursuant to ORS 28.010 et seq. But by statute, declaratory relief is always discretionary with the court. Because the statutory provisions for judicial review of administrative action contain their own "mini" declaratory relief provision (relief which has already been exercised above), this Court finds further relief under the Declaratory Judgment statute to be unnecessary and, therefore, ultimately unwarranted. See Brooks v. Dierker, 275 Or 619, 624, 552 P2d 553 (1976).

THE EMPLOYERS' ATTORNEY'S FEE CLAIM

The petitioning employers also request that this Court assess reasonable attorney's fees and costs in accordance with ORS 183.497. That statute provides that petitioners who are successful in challenging an adverse administrative order "shall" be allowed reasonable attorney's fees and costs from the funds allocated to the agency. Furthermore, in this case the actions of a relatively small group of petitioning employers will result in significant savings to all PERS employees. By reducing the risk to the system, and thereby increasing its strength and resiliency, the employee members can benefit as well. Accordingly, an award of attorney's fees and costs to the petitioning employers is not only required by law, but it is also well justified in this case as a matter of simple equity.

THE INTERVENORS' PETITION

The intervening employees raised two challenges to the March 2000 earnings allocation order. Both claims relate to the Board's decision to allow the employer accounts to participate in the allocation of the 1999 Variable Account earnings without having been invested in that account during the 1999 investment year. The employees contend that the Board's action was both a breach of its fiduciary duties, and a breach of contract.

The breach of fiduciary duties issue was decided in favor of the intervening employees at the time of the Summary Judgment. (See pages 22-25 of this Court's prior opinion.) Since there was no prior statutory authority to divert earnings on employee accounts invested in the variable fund to employer accounts, the Board's diversion of income earned on the employee funds to the employers was found to be a direct violation of the Board's fiduciary duties to the employee members. ORS 238.630 and 238.660 (2). As a trustee, the Board had an absolute duty of loyalty to the beneficiaries of the trust funds. Interest earned on those employee funds should not have been diverted from the Fund to the accounts of employers whose funds had not participated in producing those earnings and who were not beneficiaries of the Fund.

“Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interest and all consideration of the interests of third persons.”

Bogert & Bogert, the Law of Trusts and Trustees, Subsection 543, p. 217 (2nd ed. 1977) See also ORS 238.660 (2).

The second claim made by the intervening employees, that the Board's diversion of

earnings from their variable funds was a breach of contract, was deferred until a more complete record could be developed at trial. That record is now complete.

The only “contract” alleged to have been breached in this case is that formed by the provisions of the retirement statutes themselves. These statutes form part of the employment contract between the employees and their participating employers. See *Oregon State Police Officers’ Association v. State of Oregon*, 323 Or 346, 918 P2d 765 (1996), *Hughes v. State of Oregon*, 314 Or 1, 838 P2d 1018 (1992). The evidence of that breach is that same evidence demonstrating the Board’s breach of its fiduciary duties. The statutorily unauthorized distribution of earnings on employee accounts held in the variable fund to the employer accounts conflicts with the overall statutory scheme established by the legislature for public employee retirement, and in particular, with ORS 238.250 and ORS 238.260. The statutes contemplate that all earnings on employee funds which are not needed for other enumerated statutory purposes should be credited to the employee accounts.

The Intervenor employees are therefore entitled to prevail on both the breach of contract and the breach of fiduciary duties claims alleged in their petition. Moreover, like the petitioning employers, they also are entitled to recover the attorney’s fees and costs incurred in pursuing their claims in this forum.

CONCLUSION

This Court, in accordance with its own statutory duties pursuant to ORS 183.484 through 183.497, has now set forth the proper interpretation of the PERS statutes and has reviewed each of the Board’s orders challenged by the petitioning employers and by the intervening employees. Each of those challenged orders is hereby reversed on the grounds and for the reasons set forth

above, and those orders are remanded back to the Board for further action in accordance with the orders of this Court. Counsel for Petitioners may prepare a judgment in accordance herewith.

Upon remand, the Board must issue new employer rate orders for 1998 and 2000, and a new earnings allocation order for the 1999 investment year. These new orders will inevitably have a significant effect not only upon the accounts of the petitioning employers, but also upon each account in the system, including the accounts of individual members.

The Board will also have to decide on remand how to administer the accounts of members who have retired since the 1999 earnings were originally allocated. Presumably, these employees retired upon PERS' representation that in doing so they would be entitled to a certain level of retirement benefits. It would not necessarily be legally permissible to simply readjust the benefits of the retired members since they have given up their public employment positions and changed their legal position by accepting one of the PERS' retirement options, although there is some apparent statutory authority for doing so. See ORS 238.715. Accordingly, the Board should also consider other potential options, such as utilizing the Contingency Reserve provided for in ORS 238.670 (1) or the Benefits-in-Force Reserve established in accordance with subsection (2) of ORS 238.670. The Board may also need to consider treating any funding shortfalls resulting from its recalculation of the employer contribution rates on remand as an administrative expense.¹⁶ These are all decisions entrusted to the Board's discretion in the first instance by the legislature. See ORS 238.610.

Dated this _____ day of October, 2002.

¹⁶ But cf. ORS 238.610 (4).

Hon. Paul J. Lipscomb
Presiding Judge

PJL:kja