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*Practice Group(s):*  
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## Changing the Rules in the Middle of the Game: Oregon Supreme Court Allows Prospective Modifications to Public Pension Benefits

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The national debate on public pension plans is beginning to resonate in the court system. On April 30, 2015, the Oregon Supreme Court ruled on the constitutionality of two legislative amendments that modified certain benefits of Oregon's Public Employee Retirement System ("PERS").<sup>1</sup> The benefits in question under *Moro v. State of Oregon* included a cost-of-living adjustment ("COLA") and an income tax offset. In a unanimous decision, the court held that the PERS members challenging the amendments "have a contractual right to receive the pre-amendment COLA for benefits that they earned *before* the effective dates of the amendments...[but the members] have no contractual right to receive the pre-amendment COLA for benefits earned *on or after* the effective dates of the amendments[.]"<sup>2</sup>

The decision is notable because the court rejected its prior view of "vested rights" and adopted a new analysis on the nature of pension promises. Under this new reasoning, an offer of pension benefits is made to the employee *each day* the employee works, and unless the promise is expressly irrevocable, the employer may, under contract law, change the offer each day. The result: public employees in Oregon have a contractual right only to benefits actually earned, and employers may reduce certain types of pension benefits (including COLAs) on a prospective basis for active employees without breaching any of their employees' contractual rights.

Last week, the Illinois Supreme Court addressed analogous issues and took a different approach. We will publish an alert summarizing the Illinois decision soon.

### Response to Recession Funding Shortage

During the Recession of 2008, PERS's investments lost 27% of the fund's value. The fund went from being 98% funded to 71% funded within the period of one year. The PERS board was forced to increase employer contribution rates to 16.3% in 2010 and 21.4% in 2012. In response, the Oregon legislature passed two amendments in 2013 to reduce employer contribution rates by reducing current and future benefits owed to PERS members. Specifically, the amendments modified the COLA and eliminated the income tax offset.

### The COLA and the Income Tax Offset

Most PERS members' retirement benefits are increased by a COLA and an income tax offset. The COLA increases the benefits of retired members to account for changes in the cost of living. Before 2013, the COLA was calculated according to the Portland Consumer

<sup>1</sup> *Moro v. State of Oregon*, 357 Or. 167 (2015).

<sup>2</sup> *Id.* at 173.

## Changing the Rules in the Middle of the Game: Oregon Supreme Court Allows Prospective Modifications to Public Pension Benefits

Price Index (“CPI”) at a cap of 2% per year. Changes in the CPI above or below the COLA cap were banked for later years. A 2013 amendment converted the COLA benefit to a fixed 1.25% COLA that was not based on the Portland CPI and was no longer subject to a cap or bank.

Previously, PERS retirement benefits were exempt from Oregon income tax. Federal employees, who did not benefit from this tax exemption, sued and won.<sup>3</sup> In response, the Oregon legislature eliminated the income tax exemption, but enacted an offset (ranging from 1% to 4%) to mitigate anticipated damages from PERS members no longer able to claim the exemption. The offset was not available to out-of-state residents or those otherwise exempt from Oregon income taxation.

### Court Uses Modified “Vested Rights” Analysis

The Oregon Supreme Court found PERS is a contract between a participating employer and its employee. Each participating employer offers a promise to its employees to provide compensation, including PERS benefits, in exchange for the employee’s services. The salary and PERS benefits are treated the same: a continuing offer of compensation that remains open for a series of acceptances and results in a series of separate contracts every day the employee goes to work.

The court found the income tax offset was *not* part of the PERS contract: “[The offset was] not an offer to PERS members inviting them to render services. It was, instead, a noncontractual payment...intended to limit the amount of the employers’ liability if a breach of contract were later established.”<sup>4</sup>

In contrast, the court found the COLA *was* part of the PERS contract. The court focused on the “unmistakable contractual intent” of the PERS legislation as well as the fact the COLA was both remunerative and mandatory.<sup>5</sup> Because the COLA was part of the PERS contract, members were entitled to have the pre-amendment COLA applied to benefits earned before the amendments went into effect. However, “the right that they accrued did not require the employers to continue *offering* [the COLA]...For that reason, participating employers could change, and thus revoke, the *offer*...[because] the COLA benefit accrues incrementally as a PERS member renders additional service to his or her employer.”<sup>6</sup> PERS members who earned a contractual right to benefits by working both before and after the amendments’ effective dates were entitled to receive a blended COLA rate.

As the court itself noted, this reasoning conflicts with prior Oregon case law. In *Hughes v. State of Oregon*, the Oregon Supreme Court explained, “[a]n employee’s contract right to pension benefits becomes *vested at the time of his or her acceptance of employment*...On vesting, an employee’s contractual interest in a pension plan may not be substantially impaired by subsequent legislation.”<sup>7</sup> Likewise, in *OSPOA v. State of Oregon*, the court reiterated this view and held that an employee’s right to a pension benefit vested on

<sup>3</sup> *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989).

<sup>4</sup> *Moro* at 207.

<sup>5</sup> *Strunk v. PERB*, 338 Or. 145, 108 P.3d 1058 (2005).

<sup>6</sup> *Moro* at 224.

<sup>7</sup> 314 Or. 1, 20 (1992) (emphasis added).

## Changing the Rules in the Middle of the Game: Oregon Supreme Court Allows Prospective Modifications to Public Pension Benefits

acceptance of employment and thus encompassed service that accrues through the course of the employee's tenure—"work that has not yet begun."<sup>8</sup>

In *Moro*, the court rejected the reasoning of these cases. Because pension benefits are contracted for and vest on a daily basis, the legislature may change its offer of future benefits on any given day. The court cites a federal case to define "vesting" as "the process by which an employee's already-accrued pension account becomes irrevocably [the employee's] property[.]"<sup>9</sup> Creating a new distinction, the court finds that implied "irrevocability" applies to only those offers that are accepted by performance that takes time to complete.<sup>10</sup> As an example, the court cites an Oregon case in which a corrections officer was eligible to participate in a pension plan if he worked for 20 years.<sup>11</sup> This is the type of contract performance that takes time to complete. It would be unfair for the officer to work for 10 years and then have the unilateral offer of pension eligibility be revoked. In contrast, the COLA benefits vest on a daily basis, do not take time to complete, and therefore are revocable.

Finally, the *Moro* court refused to uphold the COLA modifications using police powers or public purpose analysis. The court recognized that sufficient public purpose may justify the impairment of a state contract in two circumstances: (1) if adhering to it would require the state to "surrender an essential attribute of its sovereignty" or (2) the impairment is "reasonable and necessary to serve an important public purpose."<sup>12</sup> The State argued the COLA modification would bring additional funding for public safety and education, but they failed to establish the inadequacy of such public services and demonstrate that those deficiencies could not be remedied through funding from other sources.

### Related Suits in Other States

During the Recession, many states' pension funds experienced losses on their investments, and so they tried to bridge the funding gap by reducing retirement benefits like the COLA. Employees in several jurisdictions sued, and state courts have used differing approaches to address pension benefits modifications.<sup>13</sup>

*Justus v. State of Colorado* involved a group of retired employees who sued the state after it modified their COLA.<sup>14</sup> The Colorado Supreme Court focused on the non-mandatory language of the statute and held the members were not entitled to the specific COLA formula in place on their retirement dates: "By its very nature, a statutory cost of living adjustment is a periodic exercise of legislative discretion that takes account of changing economic conditions in the state and/or nation" and may be adjusted by the legislature.<sup>15</sup>

<sup>8</sup> 323 Or. 356, 371 (1996).

<sup>9</sup> *Moro* at 199 (citing *Central Laborers' Pension Fund v. Heinz*, 541 U.S. 739, 749 (2004)).

<sup>10</sup> *Moro* at 224.

<sup>11</sup> *Taylor v. Mult. Dep. Sher. Ret. Bd.*, 11 Or. App. 488 (1972).

<sup>12</sup> *Moro* at 229.

<sup>13</sup> See Eric M. Madiar, *Public Pension Benefits Under Seige: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants?* 27 A.B.A. J. Lab. & Emp't L. 179 (2012), discussing four different legal approaches to how states protect public pensions: (1) contractual; (2) proprietary; (3) promissory estoppel; and (4) gratuity.

<sup>14</sup> 336 P.3d 202 (2014).

<sup>15</sup> *Id.* at 209.

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In recent years, almost two-thirds of U.S. states have curbed employee pension benefits or raised required contributions.<sup>16</sup> Many pension funds continue to face funding shortages, and lawsuits challenging pension benefit cuts will be heard in coming years.

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<sup>16</sup> Andrew M. Harris and William Selway, "Colorado, Minnesota Courts Toss Retiree Benefit-Cut Suits," *Bloomberg Business* (June 30, 2011), <http://www.bloomberg.com/news/articles/2011-06-30/colorado-minnesota-state-courts-toss-retiree-pension-benefit-cut-lawsuits>.