GOING FOR BROKE: Arizona's Legal Protection of Public Pension Benefits

Hayleigh S. Crawford*

*. J.D. Candidate, 2014, Sandra Day O'Connor College of Law at Arizona State University; B.A., Plan II Honors, 2007, University of Texas at Austin. I am grateful for the help and advice of Colin Campbell, Sharad Desai, and Professor Zachary Gubler. I owe a special thank you to Ron Kilgard for going above and beyond in sharing his impressive knowledge and answering even the simplest of pension questions with enthusiasm.

TABLE OF CONTENTS

I. INTRODUCTION

In 2012, public pension systems responsible for providing retirement benefits for hundreds of thousands of state employees were underfunded by an estimated one trillion dollars.[1] The recent recession's enormous toll on investment earnings, combined with many states' failures to make the required contributions to their retirement funds, has left state legislatures, employees, and taxpayers with a looming debt and few palatable options.

Arizona is no exception to the nationwide public pension problem. Within ten years, Arizona's pension funds have gone from "healthy" to seriously underfunded.[2] As a result, Arizona taxpayers are paying more than ever for public employee retirement benefits: in 2010, Arizona taxpayers were paying paid at least $1.39 billion annually to fund the state pension systems, more money than the estimated cost for higher education, corrections, or an indigent healthcare program.[3] That pension liability represented a 448% increase in pension costs over the past ten years.[4] With Arizona's state budget projecting a deficit of $1.24 billion between fiscal years 2012 and 2014, the state legislature has been forced to take a hard look at pension reform options.[5]

Between 2009 and 2012, every state in the nation enacted some type of pension reform legislation.[6] In Arizona, the legislature passed bills in 2010 and 2011 aimed at reducing the cost of the state's pension plans.[7] However, Arizona faces a tougher road to pension reform than many other states

---

1. *See, e.g.*, PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROAD TO REFORM 1–3 (2010).

2. *See* PEW CTR. ON THE STATES, ARIZONA'S PENSION CHALLENGES: THE NEED FOR AN AFFORDABLE, SECURE, AND SUSTAINABLE RETIREMENT PLAN, 1, 1 (2012), *available at* http://www.aztreasury.gov/wp-content/uploads/2012/02/AZ-Pension-Challenges-Report1.pdf.

3. Craig Harris, *Arizona Pension Systems, a Soaring Burden: Arizona Pension Plan for Police, Fire Adds to Cost, Day 3*, ARIZ. REPUBLIC, Nov. 16, 2010, http://www.azcentral.com/news/articles/arizona-pension-funds-publicsafety.html.

4. Craig Harris, *Arizona Pension Systems, a Soaring Burden, Day 1*, ARIZ. REPUBLIC, Nov. 14, 2010, http://www.azcentral.com/news/articles/2010/11/12/20101112arizona-pension-funds.html.

5. *See* OFFICE OF THE GOVERNOR, SUMMARY OF THE EXECUTIVE BUDGET, FISCAL YEAR 2013, at 4 (2012), *available at* http://www.ospb.state.az.us/Budbooks.asp (estimating the structural deficit to be $1,242,607,900). It should be noted that Arizona's fiscal year generally ends on June 30th and budget projections are made accordingly. *See* OFFICE OF THE GOVERNOR, SUMMARY OF THE EXECUTIVE BUDGET, FISCAL YEAR 2012, at 9 (2011), *available at* http://www.ospb.state.az.us/Budbooks.asp.

6. *See, e.g.*, RONALD K. SNELL, PENSION AND RETIREMENT PLAN ENACTMENTS IN 2011 STATE LEGISLATURES 1 (2012), *available at* http://www.ncsl.org/documents/employ/2011EnactmentsFinalReport.pdf.

7. *See, e.g.*, 2011 Ariz. Sess. Laws, 1st Reg. Sess. ch. 357 [hereinafter S.B. 1609]; 2011 Ariz. Sess. Laws, 1st Reg. Sess. ch. 26 [hereinafter S.B. 1614].

because Arizona takes a contractual approach to protecting pensions.[8] Under this approach, the State is forbidden from unilaterally modifying pension benefits.[9] Additionally, Article XXIX of the Arizona Constitution, the "Retirement" or "Pension Clause," forbids the legislature from "diminish[ing] or impair[ing]" public pension benefits.[10] The courts have interpreted this language, in conjunction with the State's Contracts Clause, as a broad prohibition on virtually any modification of existing pension benefits and liabilities, including those due in the future to current employees.[11] As a result, the legislature's cost-cutting attempts have proven largely unsuccessful.[12] Arizona courts have already rejected two of the primary reform bills, Senate Bill 1609 and Senate Bill 1614, as unconstitutional.[13]

Given this economic and legal backdrop of public pension reform, this article argues that Arizona's constitutional protection of public pension benefits and case law misapplies a contractual theory of benefits, which unnecessarily restricts the legislature's ability to reform those benefits. Further, Arizona voters' 1998 adoption of Article XXIX to the State Constitution has enabled courts to extend the flawed contractual approach far beyond its original scope and purpose.[14]

This article proposes that because other statutory and constitutional protections, such as the state and federal Contracts Clauses, provide sufficient protection from legislative overreaching, the "strict" contractual approach that Arizona takes to pension benefit protection is too rigid and thus interferes with the legislature's ability to ensure the solvency of its retirement systems. As a result, Arizona's sharp restrictions on pension reform may actually harm the long-term interests of public employees and taxpayers. This article suggests that because public employees and taxpayers may be better served by a more flexible legislative role in pension reform, Arizona should consider amending its constitution to more clearly

---

8. ARIZ. CONST. art. II, § 25 ("No bill of attainder, ex-post-facto law, or law impairing the obligation of a contract, shall ever be enacted."); ARIZ. CONST. art. XXIX, § 1(C) ("Membership in a public retirement system is a contractual relationship that is subject to article II, section 25 . . . .").

9. *See* ARIZ. CONST. art. XXIX, § 1(C); *see, e.g.*, Yeazell v. Copins, 402 P.2d 541, 545–46 (Ariz. 1965).

10. ARIZ. CONST. art. XXIX, § 1.

11. *See, e.g.*, Barnes v. Ariz. State Ret. Sys., CV 2011-011638, 3 (Ariz. Super. Ct. Maricopa Cnty. Feb. 1, 2012).

12. *See Barnes*, CV 2011-011638 at 3–4 (finding S.B. 1614 unconstitutional); Fields v. Elected Officials' Ret. Plan, No. CV-13-0005-T-AP, 2014 WL 644467, at *1 (Ariz. 2014) (holding S.B. 1609 unconstitutional).

13. *Fields*, 2014 WL 644467, at *1; *Barnes*, CV 2011-011638 at 3–4.

14. *See infra* note 185 and accompanying text.

define the scope of Article XXIX. Alternatively, Arizona could adopt a limited vesting approach that allows the Legislature to make reasonable modifications to the benefits of current employees, prior to retirement or retirement-eligibility.

Part II explains the two most common types of pension plans and their structural implications. Part III canvasses the approaches used by the various states to afford public pension benefits legal protection. Parts IV and V provide a brief history of Arizona's state retirement system and the current laws and constitutional protections pertaining to them. Part VI offers a synopsis of recent litigation relating to the Arizona legislature's attempts to reform the State's public pension systems. Part VII analyzes Arizona's current legal protection of pension benefits and suggests alternative reform options.

II. HOW PENSIONS WORK: DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

The term "pension" in the context of "pension reform" is used to refer to employer-provided retirement plans. Generally, employer-provided retirement plans are funded by a combination of employee and employer contributions.[15] The contributed funds are invested and subsequently paid out to eligible employees upon retirement.[16] Pension plans generally fall into two categories: (1) defined benefit plans; or (2) defined contribution plans.[17]

To properly analyze the ramifications of potential pension reforms, it is critical to understand how these plans are funded and valued, as well as the various factors that affect their fiscal health. Parts (A) and (B) describe the two plan types. Part (C) explains how pension plans are valued and the factors that affect those calculations, and Part (D) examines the current status of Arizona's retirement plans.

A. Defined Benefit Plans

A defined benefit plan is funded by employer and employee contributions and guarantees the employee a certain benefit upon

15. *See* ROBERT J. LYNN, THE PENSION CRISIS 5–6 (1983).
16. Olivia S. Mitchell et al., *Developments in State & Local Pension Plans*, *in* PENSIONS IN THE PUBLIC SECTOR 11–12 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001).
17. LYNN, *supra* note 15, at 3–4.

retirement.[18] The contribution rates are based on the employee's salary and an annual actuarial valuation;[19] however, the ultimate benefit the employee receives does not depend on the investment performance of the funds. Rather, the employee's benefit is based on average wage,[20] years of service, and a "benefit multiplier," generally set by state statute and tied to years of credited employee service.[21] This formula "defines" the benefit the employee is obligated to receive upon retirement. Additionally, some plans provide for additional benefits, such as automatic cost-of-living adjustments, which are added to the employee's retirement benefit as calculated by the formula.[22]

B. Defined Contribution Plans

In contrast, a defined contribution plan does not provide any guaranteed future benefit.[23] An employee elects to contribute pre-tax earnings to the plan, which are often "matched" by employers, and receives a benefit based on the performance of the funds at retirement.[24] The private-sector 401(k) is a common example of a defined contribution plan.

---

18. *Pension Tension: Understanding Arizona's Public Employee Retirement Plans*, ARIZ. CHAMBER FOUND. POL'Y BRIEF, June 2010, at 1 [hereinafter *Pension Tension*], *available at* http://www.azchamber.com/assets/files/Foundation/Reg%20Reform/Pension%20Tension.pdf. Note, however, that defined benefit plans do not require employee contributions by definition; many private defined benefit plans are funded only by employer contributions.

19. An actuarial valuation is a method of calculating future liabilities. It is used to predict the amount of contributions necessary to keep a fund solvent; i.e., to ensure the fund is able to meet the future retirement benefits it owes. According to Investopedia.com, "An actuarial valuation is a type of appraisal which requires making economic and demographic assumptions in order to estimate future liabilities. The assumptions are typically based on a mix of statistical studies and experienced judgment. Since assumptions are often derived from long-term data, unusual short-term conditions or unanticipated trends can occasionally cause problems." *Actuarial Valuation Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/a/actuarial-valuation.asp#axzz2HP19unwY (last visited March 22, 2014).

20. *Pension Tension*, *supra* note 18, at 3. The method for determining "average wage" for the benefit formula is set statutorily and may be adjusted for future employee members. For example, prior to the recent legislative reforms to the Arizona State Retirement System ("ASRS"), the average salary was calculated using the highest thirty-six consecutive months out of the prior 120. In 2010, the formula was changed so that the average salary is now calculated based on the highest sixty consecutive months out of the last 120. *Id.* at 5. This was intended to prevent "spiking," or raising an employee's salary in the years directly preceding retirement to enable the employee to receive a higher payout. *Id.*

21. *Pension Tension*, *supra* note 18, at 2.

22. *Id.* at 3.

23. *Id.* at 2.

24. *Id.*

The critical distinction between defined benefit and defined contribution plans is the party who bears the investment risk. In a defined benefit plan, an employee is entitled to the formula-based benefit regardless of investment performance.[25] Because employers are contractually obligated under defined benefit plans, if the fund underperforms or is underfunded, the employer must make up the difference in what is owed to the employee.[26] In contrast, a defined contribution plan places the entire investment risk on the employee; although employers may obligate themselves to make contributions, they are under no contractual obligation to provide a specific benefit at retirement.[27]

Defined benefit plans are most common in the public sector, while most private sector plans are defined contribution.[28] Union membership and collective bargaining is thought to be a primary factor in the difference between availability of defined benefit plans to private employees, given that only 7.2% of the private workforce is unionized, as compared to 39% of the public sector.[29] The recent trend in the public sector is to shift retirement plans from defined benefit to defined contribution, or some hybrid of the two.[30] However, from an employee perspective, a defined benefit plan provides significantly more retirement security than a defined contribution plan.[31] In fact, defined benefit plans are often identified as one of the primary motivations for employees to join the public sector and thus

---

25. *Id.* at 1–2.

26. *See* ARIZ. CONST. art. XXIX, § 1(A); ARIZ. REV. STAT. ANN. § 38-810(c) (2013).

27. *Pension Tension*, *supra* note 18, at 2.

28. *Id.* at 1.

29. *Id.* at 2.

30. For example, Indiana, Rhode Island, and Utah all passed legislation in 2011 either creating a defined contribution plan or creating a "hybrid" plan by introducing defined contribution elements into their existing defined benefit plans. SNELL, *supra* note 6, at 32–34. As discussed in Part VI, the Arizona Legislature has considered proposals from legislative study committees proposing a shift from a defined benefit to defined contribution system. *See, e.g.*, Craig Harris, *Study: Arizona Pensions Should Offer 401(k)*, ARIZ. REPUBLIC, Dec. 20, 2012, http://www.azcentral.com/news/politics/articles/20121220arizona-pensions-should-offer-401k-study-says.html; *supra* note 294 (noting the realization of this particular prediction in Arizona).

31. Some scholars suggest that the replacement of defined benefit plans with defined contribution plans may be economically unviable, as most employees will never earn nor save enough money in a defined contribution plan to support themselves in retirement. *See, e.g.*, Edward A. Zelinksy, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 458–62 (2004); PAULA SANFORD & JOSHUA M. FRANZEL, THE EVOLVING ROLE OF DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR 8–10 (2012), *available at* http://www.nagdca.org/documents/ANC_NAGDCA_SLGE_The_Evolving_Role_of_Defined_Contribution_Plans_in_the_Public_Sector2.pdf. These concerns are relevant to the discussion in Part VII *infra*, insofar as this comment argues that strict constraints on pension reform encourage states to move towards defined contribution plans. However, an in-depth discussion of this topic is beyond the scope of this article.

many proponents argue they are necessary to enable governments to attract and retain valuable employees.[32]

C. Calculating Defined Benefit Plan Liabilities and Solvency

Much of the controversy over the funding of public pensions stems from the different accounting methods used to determine liabilities and funding levels of state pension plans.[33] Because retirement plans by definition contemplate future benefits, determining the financial health of a state-run retirement plan is not as simple as comparing current assets to current liabilities. Rather, retirement plan calculations are based on actuarial projections that estimate the future liabilities and assets of the plan to establish how much, in today's dollars, the State and employees must contribute to ensure sufficient funds for future promised payouts as they come due.[34] A variety of factors affect these future projections and contribute to the difficulty of accurately analyzing a pension fund's present solvency.

1. Liability

References to a pension's "liability" mean the Actuarial Accrued Liability ("AAL"), which represents the present value of any future retirement benefit payments.[35] To determine the present value of future cash flows, a discount rate must be used.[36] Using a higher discount rate results in a lower present value, while a lower discount rate result in higher present value. Thus, if the discount rate is overstated, then the AAL will be lower

---

32. *See* Craig Harris, *Public Pensions, a Soaring Burden*: *Generous Pension Benefits for Arizona Elected Officials, Day 2*, ARIZ. REPUBLIC, Nov. 15, 2012, http://www.azcentral.com/news/articles/arizona-pension-funds-elected.html.

33. *See, e.g.*, ANDREW G. BIGGS, GOLDWATER INST. POL'Y REPORT NO. 236, $50 BILLION TIDAL WAVE: HOW UNFUNDED PENSIONS COULD OVERWHELM ARIZONA TAXPAYERS 9 (2010), *available at* http://goldwaterinstitute.org/sites/default/files/50%20Billion%20Dollar%20Tidal%20Wave.pdf.

34. Mitchell et al., *supra* note 16, at 23–25.

35. *Pension Tension*, *supra* note 18, at 2.

36. A "discount rate" is used to determine the present value of future cash flows by accounting for the time value of money. The time value of money is the concept that money available presently is worth more than the same amount of money in the future, both because it could be earning interest and because future cash flow is subject to risk and not guaranteed to retain value. *Discount Rate Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/d/discountrate.asp#ixzz2BBnz2NAa (last visited Mar. 22, 2014).

than the actual liability of the plan, and vice versa.[37] Discount rates of 8% to 8.5% are typical for public pension plans, but some argue that these rates are too high and thus inaccurately depict pension plans as better funded than they really are.[38] The importance of a discount rate is nicely illustrated by a 2010 Goldwater Institute report, which found that by substituting a 3.6% discount rate (one closer to the U.S. Treasury Yield rate)[39] for the 8% rate, the estimated $10 billion in unfunded pension plan liability ballooned to $50 billion.[40]

Whatever the discount rate,[41] the ultimate size of the AAL is a result of the expected annual benefit payment per employee and the number of payments per employee.[42] Thus, longer employment, higher salaries, earlier retirement ages, longer life spans, and additional employees all may increase the size of the pension's liabilities.[43] The nature of actuarial calculations requires that predictions about future cost must be based on assumptions drawn from historical data. For example, the calculation requires that estimates be made about future wage increases, mortality rates, and marriage assumptions (for calculating survivor benefits).[44] Given the numerous underlying assumptions that necessarily must be made, actuarial calculations may not accurately reflect the liability of a pension plan.[45]

---

37. *Pension Tension*, *supra* note 18, at 4.

38. *See, e.g.*, BIGGS, *supra* note 33, at 9.

39. The Arizona Chamber Foundation has suggested tying the discount rate to the U.S. Treasury Yield rate. *See Pension Tension*, *supra* note 18, at 5. It is worth noting that the Treasury Yield rate has dropped even lower (from around 4% to less than 3%) since those reports were published. *Daily Treasury Yield Curve Rates*, U.S. DEP'T OF THE TREASURY, RESOURCE CTR., http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield.

40. BIGGS, *supra* note 33, at. 9 tbl.2, 14 tbl.3.

41. The Governmental Accounting Standards Board recently released updated statements on the accounting and financial reporting requirements for public pensions. The new statement requires that the discount rate used to calculate actuarial present value be a single rate "that reflects (1) a long-term expected rate of return on pension plan investments to the extent that the pension plan's fiduciary net position is projected to be sufficient to pay benefits and . . . plan assets are expected to be invested using a strategy to achieve that return and (2) a tax-exempthigh-quality municipal bond rate to the extent that the conditions for use of the long-term expected rate of return are not met." *Summary of Statement No. 68*, GOVERNMENTAL ACCOUNTING STANDARDS BD. (June 2012), http://www.gasb.org/cs/ContentServer?site=GASB&c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176160219492.

42. *Pension Tension*, *supra* note 18, at 3.

43. *Id.*

44. *See, e.g.*, GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT E-8 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

45. *Id.* at i.

2. Assets

A pension fund's assets are composed of the net contributions (money contributed by active members minus benefits distributed to retirees) and investment income.[46] Generally, the actuary sets the annual contribution for members and employers by predicting the contribution necessary to ensure that the assets of the plan can adequately cover the future liabilities.[47]

Contribution rates: The contribution rate actually consists of two parts: (1) the normal cost, which is the present value of the accrued retirement benefits earned by an employee in a year's time, and (2) the Unfunded Actuarial Accrued Liabilities ("UAAL") amortization payment.[48] The UAAL is the actuarial accrued liability that is unfunded because of negative investment returns, inaccurate actuarial assumptions, and failure of participants to make adequate contributions in the past.[49] The UAAL is amortized over a period of time, and these amortization payments are included in the annual contribution rate.[50] Consequently, in years that a pension has high UAAL, the annual contribution rate will increase. Notably, if a retirement plan provides for set employee contribution rates, any increases in required contributions will necessarily have to come from the employer.[51] In a few states, including Arizona, the state is required by law to make the annual contribution set by the actuary; in others, the state is free

46. To estimate the required annual contributions, an actuary must make assumptions about future investment returns. Like the discount rate, there is considerable disagreement over the proper investment return rate to use. For example, the actuarial report for the Elected Officials' Retirement Plan in 2010 noted that the 8.5% assumed investment return rate used in its calculations was "extremely aggressive" in light of the cost-of-living adjustment ("COLA") benefits provided under that plan. GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT E-2 (June 30, 2010), *available at* http://www.psprs.com/sys_eorp/ActuarialReports/Actuarial_10_EO.pdf. However, the assumed investment return rate was lowered only a half percent, to 8.0%, in making the 2012 actuarial report. GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT app. I-3 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

47. *See generally id.* In Arizona, the actuary sets the rates for the State's contributions, but members' rates are fixed by statute.

48. *Pension Tension*, *supra* note 18, at 3.

49. *Id.*

50. The UAAL amortization period typically varies somewhere between twenty and thirty years. For example, the ASRS's amortization period in 2010 was thirty years, while the EORP used a twenty-six-year period. *See Pension Tension*, *supra* note 18, at 3; GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT A-2 (June 30, 2010), http://www.psprs.com/sys_eorp/ActuarialReports/Actuarial_10_EO.pdf.

51. Arizona is one of the few states that require the annual actuarial contribution be made. *See* ARIZ. CONST. art. XXIX, § 1(A); ARIZ. REV. STAT. ANN. § 38-810(c) (2013).

to make a lower contribution, although this will lead to underfunding of the plan.[52]

In general, contribution rates determined by actuarial calculations will fluctuate in different years due to changes in the plan's benefits or eligibility criteria, changes in actuarial assumptions or methods, and differences in between the plan's actuarial assumptions and what actually occurred throughout the year.[53]

"Smoothing": Pension plans report the actuarial value of assets ("AVA"), rather than the fair market value of assets.[54] The AVA adjusts fair market value by "smoothing" investment returns over several years.[55] This defers both investment gains and losses and prevents contribution rates from large annual fluctuations. However, as an Arizona Chamber Foundation report notes, "[w]hile this may be helpful for budgeting purposes, it does not accurately reflect the funding level of the plan."[56]

Funding Levels: A pension plan's "funding level" or "funding ratio" is simply the ratio of a plan's current assets to its AAL, or discounted present value of liabilities.[57] The generally accepted standard for a "healthy" plan is an 80% funding ratio.[58]

While the failure of many states to make the required annual contribution is a primary reason many plans are underfunded, even states like Arizona that legally require the annual contribution to be made in full have plans

---

52. The failure of many states to pay the necessary annual contribution amount to maintain the solvency of their funds is often cited as a key reason for the current pension crisis. *See, e.g.*, PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 1 (2010), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underfunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf.

53. GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT 1 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

54. *Pension Tension*, *supra* note 18, at 4.

55. *Id.*

56. *Id.*

57. BIGGS, *supra* note 33, at 9.

58. PEW CTR. ON THE STATES, *supra* note 52, at 3. However, the American Academy of Actuaries warns "that while the funded ratio may be a useful measure, understanding a pension plan's funding progress should not be reduced to a single measure or benchmark at a single point in time." Rather, it suggests that "[p]rovided the plan sponsor has the financial means and the commitment to make the necessary contributions, a particular funded ratio does not necessarily represent a significant problem." AM. ACAD. OF ACTUARIES, ISSUE BRIEF, THE 80% PENSION FUNDING STANDARD MYTH 1–2 (2012), *available at* http://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf. Arguably, however, this places too much faith in state legislatures, many of whom are already struggling with budget constraints.

that are less than 80% funded.[59] A variety of other factors, including the discount rate, investment returns, mortality and marriage rates, and length of employment can affect the solvency of a pension fund.[60] It is vital to understand the basic accounting principles underlying pension plans when discussing pension reform options, because the current pension crisis cannot be explained away simply by pointing to a state's failure to contribute necessary funds. The fact that even states like Arizona that continue to make the annual required contribution each year are still unable to maintain a healthily funded retirement plan indicates that the problem is much more complicated.[61]

D. Current Solvency of Arizona's Pension Plans

Although Arizona's pensions look healthy compared to some states, between the years 2000 and 2009, Arizona's collective retirement plans went from a $4 billion surplus to an estimated $10 billion deficit.[62] Arizona currently faces an estimated $13 billion shortfall.[63] The Elected Officials' Retirement Plan ("EORP") provides a stark example: its funding ratio has steadily dropped from 118.7% funded in 2003 to 58.4% funded in 2012.[64] Because Arizona requires the employer (in this case the State itself) to make up any shortfall in funding,[65] as the funding ratio drops, the state

---

59. *See* PEW CTR. ON THE STATES, ISSUE BRIEF, THE WIDENING GAP UPDATE 5 (2012), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf (finding the overall funding ratio for Arizona's retirement plans to be 75% in 2010).

60. *See, e.g.*, GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT 3 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

61. For example, in 2010 Arizona contributed 101% of its required contribution to its pension plans, but its plans were still only 75% funded. PEW CTR. ON THE STATES, *supra* note 59, at 5.

62. *Pension Tension*, *supra* note 18, at 4 tbl.2.

63. PEW CTR. ON THE STATES, ARIZONA'S PENSION CHALLENGES: THE NEED FOR AN AFFORDABLE, SECURE, AND SUSTAINABLE RETIREMENT PLAN 1 (2012), *available at* http://www.aztreasury.gov/wp-content/uploads/2012/02/AZ-Pension-Challenges-Report1.pdf.

64. GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT B-3 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

65. *See* ARIZ. CONST. art. XXIX, § 1(A) ("Public retirement systems *shall* be funded with contributions and investment earnings using actuarial methods and assumptions . . . ." (emphasis added)); Ariz. Op. Att'y Gen. No. I09-009, 2009 WL 4100152, at *2 (Nov. 24, 2009).

contributions increases—the 2003 employer contribution rate was 14.54%, but the state paid 39.62% in 2013.[66]

Despite Arizona's consistent payment of the required contribution to its pension plans, the funding ratios continue to drop and employer contribution rates continue to increase.[67] This is due in part to (1) the State increasing the "smoothing" period from five to ten years, which means the State was still dealing with investment losses from 2001–2002 when the recession of 2007–2009 hit; (2) a consistent failure to meet actuarial assumptions, which has increased the UAAL each year; and (3) low investment returns—actuarial assumptions have assumed an 8% rate of return, while the ten-year return has been just 5.2%.[68]

The prospect of low investment returns over the next several years is worrisome for the solvency of Arizona's funds. For example, a 2012 projection of Arizona's pension deficit was $16 billion, assuming an 8% return on investment.[69] When the numbers were run again assuming a 5% rate of return, the deficit "soar[ed] to $37 billion."[70] Whether an 8% return on investment over the next thirty years is reasonable is a contested point.[71] Ultimately, however, "[t]he point isn't that 5 percent is more likely than 8 percent. The point is that no one really knows, and the range of taxpayer risk is monumental."[72]

In addition to low investment returns, the State's pension liabilities have increased due to higher salaries, longer employment, and legislative reforms that raised benefits and expanded benefit eligibility in good fiscal years.[73] As discussed in Part V *infra*, these benefit increases can be especially problematic for Arizona because the state constitution forbids the legislature

---

66. GABRIEL ROEDER SMITH & CO., ARIZONA ELECTED OFFICIALS' RETIREMENT PLAN CONSOLIDATED REPORT A-3 (June 30, 2012), *available at* http://www.psprs.com/Admin_Investments_and_Finance/2012%20Actuarial%20Reports%20by%20System/GRS%202012%20EORP%20Annual%20Valuation.pdf.

67. PEW CTR. ON THE STATES, *supra* note 63, at 1.

68. *Id.* at 2–3.

69. Robert Robb, *Public Pension Funds are a Ticking Time Bomb*, ARIZ. REPUBLIC (Aug. 10, 2012, 12:00 AM), http://www.azcentral.com/arizonarepublic/opinions/articles/2012/08/09/20120809robb0810-public-pension-funds-ticking-time-bomb.html?nclick_check=1.

70. *Id.*

71. *See, e.g.*, *id.*

72. *Id.*

73. *Pension Tension*, *supra* note 18, at 3. Between 2000 and 2009, the Arizona Legislature increased the health insurance medical benefit, increased the maximum COLA from 3% to 4%, removed a limitation that linked COLA increases to the consumer price index (CPI), removed age restrictions for COLA eligibility, and removed the 80% of salary cap on maximum benefit sizes. *Id.* at 4.

from thereafter diminishing or impairing the benefits that it voted to provide to current members, even in drastic economic downturns.[74]

III. THE LEGAL PROTECTION OF PUBLIC EMPLOYEE BENEFITS

To understand the legal obstacles to pension reform in Arizona, it is worth comparing the various approaches that states take to providing legal protection for public pension benefits and their justifications. While private-sector pension plans are subject to federal law, public-sector plans are primarily regulated by the states, and thus, the protection varies widely in both type and scope from state to state.[75] In general, public pension benefits are legally protected under one or more of the following approaches: (1) the gratuity theory; (2) the contract theory; (3) the state constitution; or (4) the property theory.[76]

A. Gratuity Theory

Historically, pension benefits were viewed as gratuities and accorded little legal protection; the state could amend or withdraw them at any time.[77] Over time, however, the perceived unfairness of being able to remove or reduce an employee's pension at will, coupled with the evolving role of pension benefits as an incentive to take public employment, motivated many states to move away from the gratuity approach.[78] Today, most states have rejected this approach, either on public policy grounds or because the state constitution forbids the state from making gifts.[79] Only Indiana and Texas retain some limited version of the gratuity theory.[80] In those states, whether pension benefits are viewed as gratuitous or contractual depends on

---

74. *See* ARIZ. CONST. art. XXIX; *infra* Part V.

75. However, some federal law, like portions of the Internal Revenue Code, does apply to public sector plans. Anna K. Selby, *Pensions in a Pinch: Why Texas Should Reconsider its Policies on Public Retirement Benefit Protection*, 43 TEX. TECH L. REV. 1211, 1214–15 (2011).

76. *See, e.g.*, Eric M. Madiar, *Public Pension Benefits Under Siege: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants?*, 27 ABA J. LAB. & EMP. L. 179, 181 (2012).

77. Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC., FIN. & POL'Y, at *3 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573864.

78. *See, e.g.*, Yeazell v. Copins, 402 P.2d 541, 543 (Ariz. 1965); Rubin G. Cohn, *Public Employee Retirement Plans–The Nature of the Employees' Rights*, 1968 U. ILL. L.F. 32, 40–41 (1968).

79. Or for both of these reasons. *See Yeazell*, 402 P.2d at 543; Monahan, *supra* note 77, at *4.

80. *See, e.g.*, Selby, *supra* note 75, at 1230–31.

the nature of the employee's participation: mandatory plans are contractual and voluntary plans gratuitous.[81]

B. Contractual Theory

Many states that reject the gratuity approach to public pension benefits view public pension benefits as contractual, including Arizona.[82] In these states, the state and the employee are viewed as contracting parties and the employee has a right to receive his or her pension benefit under that contract. Pension benefits are generally defined as, or analogized to, deferred compensation, both to exclude them from the category of prohibited state gifts and to justify extension of contractual or vested rights to them.[83]

Benefits are protected under the Federal Contracts Clause, as well as any applicable state Contracts Clause.[84] Courts may infer the existence of a contract from legislative intent, or the contractual relationship may be expressly provided for by state statute or, more rarely, by the state constitution.[85]

To successfully assert a Contracts Clause challenge against a state, a plaintiff must establish that (1) there is a contract between the government and the plaintiff; (2) the challenged law impairs an obligation of that contract; and (3) the impairment is not reasonable and necessary to serve an important public purpose.[86] The Contracts Clause analysis thus reserves a public policy exception for reforms where the State can establish it is necessary and reasonable.[87] However, this exception is narrow, and a court is not required to give deference to a legislature where the State's self-interest is at stake.[88] For a state to successfully argue that its actions were reasonable, the change must be necessitated by unforeseeable circumstances that were neither in existence nor intended by the legislature when it entered into the contract.[89] Further, to show that its action was necessary, the state must show that (1) its purpose could not have been achieved without the

---

81. *See id.* at 1238; Cohn, *supra* note 78, at 34.
82. *See* Monahan, *supra* note 77, at *5.
83. Cohn, *supra* note 78, at 50, 52.
84. *See* U.S. CONST. art. I, § 10; ARIZ. CONST. art. II, § 25.
85. Monahan, *supra* note 77, at *5; *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 998 (1977).
86. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 17, 19–21, 25 (1977).
87. *See id.* at 17–25.
88. *Id.* at 26.
89. *Id.* at 31.

action and (2) there were no other, less drastic options available to achieve that purpose.[90]

In general, states that use the contractual approach have limited pension reform options because the "public purpose" exception to the general rule is a narrow one.[91] However, states are free to modify benefits that an employee is not vested in, meaning states are generally allowed to modify benefits for future employees.[92] Whether a state may reform member benefits after employment has commenced depends upon the approach the state takes to vesting.[93]

States take either a strict or limited approach to vesting.[94] Under the strict approach, a state finds that the members' rights vest when the contractual relationship is formed—when they begin employment.[95] In contrast, other states find that members vest at some time after employment. Thus, a contractual right to the member's benefit may arise (1) once the member actually retires and receives those benefits; (2) when the member meets the eligibility requirements to receive benefits under the plan; or (3) after each day of service provided by the employee (the "accrual" approach).[96]

California is one state that uses a "limited vesting" approach. Employees vest in their retirement benefits upon their initial employment, but prior to qualification for retirement benefits or actual retirement, the legislature may make reasonable modifications or reductions to those benefits.[97] Once an employee is retired or eligible for benefits, the employee is fully vested and his or her benefits may not be unilaterally modified or reduced.[98] Thus, California interprets the Contract Clause's "necessary and reasonable" standard to allow the state a limited amount of flexibility to modify public pension plans.[99]

An alternative accrual scheme is used in Hawaii and Michigan.[100] In these states, employees "earn" their retirement benefits as they provide

---

90. *Id.* at 26–31.

91. Monahan, *supra* note 77, at *7.

92. *Id.*

93. *Id.*

94. *See id.* at *21–22.

95. *See* Yeazell v. Copins, 402 P.2d 541, 545 (Ariz. 1965); Monahan, *supra* note 77, at *13.

96. *See* Madiar, *supra* note 76, at 181–82; Monahan, *supra* note 77, at *13 nn. 15–18.

97. Madiar, *supra* note 76, at 182–83 ("These states generally allow unilateral benefit changes that are reasonable, bear some material relation to the pension system and its successful operation, and provide employees with offsetting advantages.").

98. *Id.*

99. *Id.*

100. *See, e.g.*, Everson v. State, 228 P.3d 282, 290–91 (Haw. 2010); Request for Advisory Op., *In re* Enrolled Senate Bill 1269, 209 N.W.2d 200, 202–03 (Mich. 1973).

service; thus, the employee vests in his or her retirement benefits after each day of work.[101] These states may modify or reduce pension benefits that current employees may earn by continued employment or future service.[102] This approach mirrors the incremental approach taken under the Employee Retirement Income Security Act.[103]

C. Constitutional Protection

Among the states that take the contractual approach, a few have explicitly incorporated those protections into their state constitutions. The constitutions of Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York expressly provide that membership in a state retirement system is a contractual relationship, the benefits of which shall not be diminished or impaired.[104] But the scope of the protection among these states varies depending on the wording of their provisions and the vesting approach taken. Arizona, Illinois, and New York's constitutions provide express protection for pension benefits generally, without qualification.[105] In contrast, Alaska, Hawaii, Louisiana, and Michigan limit constitutional protection to "accrued benefits."[106]

Illinois and New York's constitutions expressly provide that member benefits are fixed when an employee begins employment and cannot be diminished or impaired after that; as such, the constitution protects both

---

101. Eric M. Madiar, *Is Welching on Public Pension Promises an Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution*, 8–9 (2013), *available at* http://ssrn.com/abstract=1774163.

102. Madiar, *supra* note 76, at 183.

103. *Id.*

104. ALA. CONST. art. XII, § 7; ARIZ. CONST. art. XXIX, § 1; HAW. CONST. art. XVI, § 2; ILL. CONST. art. XIII, § 5; LA. CONST. art. X, § 29; MICH. CONST. art. IX, § 24; N.Y. CONST. art. V, § 7.

105. ARIZ. CONST. art. XXIX, § 1; ILL. CONST. art. XIII, § 5 ("Membership in any pension or retirement system of the State . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."); N.Y. CONST. art. V, § 7 ("After July first, nineteen hundred forty, membership in any pension or retirement system of the state . . . shall be a contractual relationship, the benefits of which shall not be diminished or impaired.").

106. ALA. CONST. art. XII, § 7 ("Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired."); HAW. CONST. of 1950, art. XVI, § 2 ("Membership in any employees' retirement system of the State or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired."); LA. CONST. art. X, § 29; MICH. CONST. of 1963, art. IV, § 24 ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.").

past and future benefit accruals.[107] This means that the state legislature may not make changes to the terms of the plan, such as changing the actuarial factors, if doing so would result in a lower or diminished benefit payment to a participant than that member would have received at the time the member initially joined the plan.[108] This significantly limits the State's ability to enact pension reforms and reduce pension liabilities because changes generally may only apply to future employees to be constitutional.[109] Interestingly, despite the difference in constitutional language, Alaskan courts have also interpreted their constitution to protect both past and future benefit formulas; however, the courts also noted that the constitutional protections did not preclude modification so long as any changes that disadvantaged the members were offset by comparable new advantages.[110]

Arizona's constitutional provision is essentially identical to those in Illinois and New York, and seems to provide the same broad protection for pension benefits and restraint on legislative reform.[111] Thus, the Arizona legislature appears to be prohibited from making any changes to pension benefits that may, even indirectly, reduce a future benefit payment for current and retired employees.

The remaining states with constitutional protections, namely Hawaii, Louisiana, and Michigan, construe those protections more narrowly. In Hawaii and Michigan, courts have found that the state's constitution provides contractual right to benefits that have already been earned, but not benefits that have not been earned through service.[112] In Louisiana, "accrued benefits" has been interpreted to mean those benefits that are due and payable or vested.[113] In these states, the legislature has more flexibility in reforming pension plans because their constitutions protects only past benefits, not future accruals.[114]

D. Property Theory

Some states reject the contract theory in favor of a property theory, which treats public pension benefits as a proprietary interest of the

107. Monahan, *supra* note 77, at *7.

108. *Id.* at *8.

109. *Id.* at *10.

110. *Id.* at *9 (citing Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981)).

111. *See* Barnes v. Ariz. State Ret. Sys., CV 2011-011638, at *3 (Ariz. Super. Ct. Maricopa Cnty. Feb. 1, 2012) (holding a statutory increase in required current employee contributions to a state retirement plan unconstitutional).

112. Monahan, *supra* note 77, at *10.

113. *Id.* at *11.

114. *Id.* at *10–11.

employee, protected under the Fifth and Fourteenth Amendments of the U.S. Constitution.[115] In these states, pension benefits cannot be taken without due process of law or just compensation.[116]

The rationale for according a property interest in public pension benefits is based upon the employee's legitimate retirement expectation in receiving the promised benefits.[117] However, generally an employee is entitled only to his or her vested benefits, because "to have a property interest . . . a person clearly must have more than an abstract need or desire for it . . . . He must, instead, have a legitimate claim of entitlement to it."[118] In states that use this approach, then, an employee has a right to a pension benefit once the employee has met the statutory qualifications, but the state generally is free to make modifications to current plan funds so long as it has a rational basis for its action.[119]

The New Jersey Supreme Court noted the advantages the property approach had over the contractual approach in the case *Spina v. Consolidated Police and Firemen's Pension Fund Commission*.[120] In *Spina*, the court upheld the legislature's reform to its pension fund that increased the required employment length from twenty to twenty-five years to be eligible for benefits to help maintain the solvency of its pension plan.[121] The court rejected the contract approach as too rigid because it would preclude "legislative intervention" to maintain a plan's solvency.[122] Adopting the property approach, on the other hand, provided a middle ground whereby the state employees did have a property interest in the existing pension fund that could not be arbitrarily taken away, but also allowed the State to take reasonable steps to maintain the solvency of the plan.[123] The property approach, while advantageous from a state's point of view, is often criticized as providing too little protection from legislative overreaching.[124]

---

115. *See, e.g.*, Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 171, 175–76 (N.J. 1964).

116. Madiar, *supra* note 76, at 183–84.

117. *See Spina*, 197 A.2d at 175.

118. Monahan, *supra* note 77, at *5 (citing Bd. of Regents v. Roth, 408 U.S. 564, 577 (1972)).

119. *See Spina*, 197 A.2d at 175; *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 1003 (1977).

120. *Spina*, 197 A.2d at 169.

121. *Id.* at 170–71.

122. *Id.* at 176.

123. *Id.* at 175–76. Note, however, that the *Spina* decision focused on the State's ability to make changes to the existing pension fund generally, rather than whether the State can modify an employee's expected benefit. "Whether the interest thus secured from arbitrary action is limited to the employee's own contribution or extends to the entire fund and whether it becomes still more secure upon retirement, we need not say." *Id.* at 175.

124. Madiar, *supra* note 76, at 184; Monahan, *supra* note 77, at *31.

Understanding the variety of approaches states take to protect public pension benefits for their employees is crucial to analyzing the development of Arizona's pension protection scheme. The different theories, and more importantly, their underlying rationales, should be kept in mind when examining Arizona's pension protections.

IV. A BRIEF HISTORY OF PENSION PLANS IN ARIZONA

In 1912, Arizona paid out its first state retirement benefit in the form of a pension for schoolteachers aged sixty-five and older with a minimum of thirty years of service in Arizona schools.[125] These pensions were uniform and discretionary: if a teacher met the requirements, the legislature could grant them the $50 pension, but there were no employee contributions involved or survivor benefits attached.[126]

Arizona created its first true state retirement system, the Teachers' Retirement System, in 1943.[127] Under this system, all full-time, certified teachers were members, contributing a portion of their salaries and receiving a fixed benefit formula at retirement.[128] The State also contributed, although its contribution rate included a 5.03% cap, tied to employee salaries.[129]

In 1953, the Legislature created the Arizona State Retirement System ("ASRS") to extend retirement benefits to other state employees, including university and state political subdivision employees.[130] The original ASRS was a hybrid defined contribution plan: it required employees to contribute a specified amount to the system account, and the employee's benefit ultimately depended upon the value of the account at retirement.[131] Unlike a traditional defined contribution plan, however, the employee's account value was converted to an annuity on the date of retirement based on the employee's age.[132] Employees could receive increased annuity payments when the trust had a surplus of funds.[133] The Legislature reserved the power

---

125. ARIZONA STATE RETIREMENT SYSTEM WEBSITE: HISTORY TAB, https://www.azasrs.gov/content/our-history (last visited Mar. 20, 2014) [hereinafter ASRS WEBSITE].

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. Mgmt. of the State's Defined Contribution Ret. Sys., Ariz. Op. Att'y Gen. No. I09-009, 2009 WL 4100152, at *2 (2009).

132. In a traditional defined contribution plan, the retired employee would continue to draw on his or her accumulated account balance during retirement. *Id.*

133. *Id.*

to the ASRS to reduce or eliminate the increased "annuity payments if 'subsequent experience determine[d] that the fund [was] inadequate to maintain reserves and to pay such benefits.'"[134]

Arizona shifted the ASRS from a hybrid defined contribution system to a defined benefit retirement system in 1971.[135] Participation was elective for members of the original ASRS, while all new hires were required to participate.[136] In 1981, all non-retired members of the former hybrid defined contribution system were transferred to the defined benefit plan, and the State repealed the former system entirely in 1995.[137]

Today, Arizona has four statewide retirement plans for its public employees:[138] (1) the Arizona State Retirement System ("ASRS"); (2) the Elected Officials' Retirement Plan ("EORP"); (3) the Public Safety Personnel Retirement System ("PSPRS"); and (4) the Corrections Officers Retirement Plan ("CORP").[139] These plans are all defined benefit plans, with varying post-retirement benefits, such as cost-of-living adjustments ("COLAs") statutorily provided for.[140]

The ASRS is the largest retirement system in the state with 702 employer participants (including state agencies) covering 535,501 members.[141] The EORP has 1,957 total members as of June 30, 2011.[142] The PSPRS and CORP systems collectively cover over 45,000 active and retired members.[143]

V. ARIZONA'S LEGAL PROTECTION OF PUBLIC EMPLOYEE BENEFITS

Arizona is among the majority of states that take a contractual approach to pension benefits. Although Arizona is aligned with the majority in

134. *Id.* (quoting 1953 Ariz. Sess. Laws ch. 128, § 18(c)).

135. The Legislature agreed to enact the defined benefit retirement system if at least seventy percent of existing members voted in favor; in fact, over eighty percent voted in favor. ASRS WEBSITE, *supra* note 125.

136. *Mgmt. of the State's Defined Contribution Ret. Sys*., 2009 WL 4100152, at *2.

137. *Id.* at *3.

138. Craig Harris, *Arizona Pension Systems, a Soaring Burden: Big Pension Costs Also a Burden for Other States, Day 7*, ARIZ. REPUBLIC, Nov. 20, 2010, http://www.azcentral.com/news/articles/arizona-pensions-funds-national.html.

139. *Id.*

140. *See Retirement Plans*, SCOTTSDALEAZ.GOV, http://www.scottsdaleaz.gov/HR/benefacts/retirement (last visited Mar. 1, 2013).

141. *Facts and Figures*, ASRS WEBSITE (2014), https://www.azasrs.gov/content/facts-figures.

142. EORP COMPREHENSIVE ANNUAL FINANCIAL REPORT 26 (2011), *available at* http://www.psprs.com/sys_eorp/AnnualReports/cato_annual_rpts_EORP.htm.

143. This article will focus primarily on the ASRS and EORP and the lawsuits pertaining to those systems.

theory, early case law in Arizona established a much stricter contractual approach than that used by many other states.[144] Two key decisions, *Yeazell v. Copins* and *Thurston v. Judges' Retirement Plan*, provide much of the foundation for Arizona's broad legal protections for pension benefits.[145]

A. Yeazell v. Copins

Arizona's Supreme Court adopted the contract approach to pension benefits in the seminal pension case *Yeazell v. Copins*.[146] The plaintiff Yeazell was hired in 1942 as a police officer by the city of Tucson, where he worked for twenty years before applying for pension benefits in 1967.[147] At the time he was hired, the Police Pension Act of 1937 ("1937 Act") provided public employees with a pension equal to one-half of his or her average monthly compensation for one year prior to retirement. However, a 1952 amendment ("1952 amendment") to the 1937 Act calculated one-half of the average monthly wage for five years prior to the date of retirement, which would result in the Yeazell receiving $7.21 a month less than he would receive under the 1937 Act.[148] Yeazell sued, arguing that he was entitled to his pension benefits as calculated by the formula in place at the time he was hired.[149] The Supreme Court agreed, holding that a public employee has a contractual interest in his or her pension and that the contractual protections for that interest arise at the time the employee is hired by the state.[150]

The Court explained its shift to a contractual theory of benefits as necessary to maintain the constitutionality of state pension funds in light of Arizona's gift clause, which forbids the State from "mak[ing] any donation . . . to any individual, association, or corporation."[151] The theory of pension benefits as a form of deferred compensation provided a basis for viewing pension benefits as terms of the contract.[152] The Court rejected its own

---

144. *See, e.g.*, Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965).

145. Thurston v. Judges' Ret. Plan, 876 P.2d 545 (Ariz. 1994); Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965).

146. *Yeazell*, 402 P.2d at 542.

147. *Id.*

148. *Id.*

149. *Id.*

150. "[T]he right to a pension becomes a vested one upon acceptance of employment by an applicant . . . . As of the time he joined the fund, his right to continued membership therein, under the same rules and regulations existing at the time of his employment, was complete and vested." *Id.* at 545–46 (citations and internal quotation omitted).

151. ARIZ. CONST. art. IX, § 7.

152. *Yeazell*, 402 P.2d at 543–44 ("But where, as here, services are rendered under such a pension statute, the pension provisions become a part of the contemplated compensation for

earlier categorization of pension benefits as quasi-contractual and apparently adopted a strict contractual approach, stating that "[c]ontroversies as to those rights should be settled consistent with the law applicable to contracts."[153] However, the Court acknowledged that contract principles may allow modification of pension benefits with the mutual intent of both parties or under the doctrine of mutual mistake if the plan were actuarially unsound, because in that situation "both Tucson and appellant [would have] labored under the mistaken assumption that there was a fund sufficient to afford appellant and the other beneficiaries . . . the amount provided by the act."[154]

In sum, the *Yeazell* decision establishes that in Arizona, a public employee becomes vested in a contractual right to his or her pension benefits at the time of hiring which cannot be unilaterally modified or removed by the State. However, modifications may be made under general contract principles such as the doctrine of mutual mistake. Interestingly, the majority opinion does not discuss how pension benefit cases would be analyzed under the state or federal Contracts Clauses.

Justice Udall wrote what has been called a "withering" dissent.[155] Justice Udall questioned the validity of the contract principles the *Yeazell* majority claimed to rely on in reaching its conclusion.[156] First, Justice Udall noted that the majority cites California precedent when adopting a strict contractual approach; however, California follows a limited vesting approach that allows the legislature to make reasonable modifications or reductions to employee benefits prior to retirement "to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system."[157] Udall argued that if the majority did in fact apply the law of the jurisdictions cited, the 1952 amendment would be valid.[158]

Further, Justice Udall highlighted the inconsistency of allowing an employee to claim the retirement benefits of an earlier amendment, while also finding that "he is obviously estopped from being reimbursed or from withdrawing any additional contributions above the two per cent required" by the 1937 Act at the time he was hired.[159] Under a strict contractual theory, "[i]f he is not estopped to claim benefits under the 1937 Act . . . , it

---

those services, and so in a sense a part of the contract of employment itself.") (internal citations and quotations omitted).

153. *Id.* at 544.
154. *Id.* at 546.
155. Cohn, *supra* note 78, at 45.
156. *See Yeazell*, 402 P.2d at 547 (Udall, J., dissenting).
157. *Id.* at 547–48 (internal quotation and citation omitted).
158. *Id.*
159. *Id.* at 546.

should logically follow that he is not estopped from claiming he paid 3% too much . . . [until] he retired."[160] Thus, the majority misapplied its own strict contractual theory, even as it purported to reject a quasi-contractual theory.[161]

Ultimately, Justice Udall criticized the majority for succumbing to the "labeling process" to fix the gratuity problem instead of analyzing the purpose behind the contractual theory.[162] In addition to the criticisms noted above, this "[a]lso left in a state of confusion . . . the rights of . . . employees already retired."[163] By way of example, Justice Udall noted that the 1952 amendment increased the survivor benefit from one-third to two-thirds.[164] Under a "true" strict contractual approach, if an employee elected to take benefits under the 1937 Act and subsequently died, his widow would be "forever bound" by her spouse's election and would receive half of the benefit she would have received under the 1952 amendment.[165]

B. Thurston v. Judges' Retirement Plan

Thurston v. Judges' Retirement Plan further compounded the inconsistencies of the contractual approach established in *Yeazell*.[166] In *Thurston*, the Court was faced with almost the exact problem that Justice Udall posed in his dissent.[167] The widow of plan member Judge Thurston applied for survivor benefits at a two-thirds rate of her husband's retirement benefit.[168] At the time Judge Thurston was hired, the plan provided a one-third survivor benefit; however, after Judge Thurston's retirement, but prior to his death, the Legislature increased the survivor benefit to two-thirds.[169] When Mrs. Thurston was given a one-third benefit, she sued, claiming entitlement to two-thirds of the benefit her husband was receiving at the time of his death.[170]

The Court determined that although Mrs. Thurston was not vested in any survivor benefit until her husband's death, whether the survivor benefit *rate* vested at the time Judge Thurston was hired or when she became vested in

---

160. *Id.* at 550.
161. *Id.* at 549.
162. *Id.*
163. *Id.* at 550.
164. *Id.* at 548.
165. *Id.* at 551.
166. Thurston v. Judges' Ret. Plan, 876 P.2d 545 (Ariz. 1994).
167. *See Yeazell*, 402 P.2d at 551 (Udall, J., dissenting).
168. *Thurston*, 876 P.2d at 546.
169. *Id.*
170. *Id.*

the survivor benefit was irrelevant,[171] because any *beneficial* change to an employee's pension benefit is automatically incorporated into his or her contractual pension rights.[172] The Court further explained that acceptance of a beneficial change can be inferred or implied; however, any detrimental change requires *express* acceptance on the part of the employee.[173]

To reach this result, the Court read a tort case[174] that found "substantive rights may not be impaired once vested," to mean "that substantive rights may be statutorily altered prior to vesting."[175] Thus, the Court reasoned that because the amendment was enacted prior to Ms. Thurston vesting in her survivor benefit, she was entitled to the two-thirds rate.[176]

Yeazell and *Thurston* arguably raised more questions than they provided answers. The creation of legislative contracts in the area of pension benefits was justified as an avoidance of the state constitution's Gift Clause, but it created inconsistent results. The most striking is the direct contradiction of the majority's conclusion in *Thurston* to the result Justice Udall felt the strict contractual approach required in *Yeazell*.[177] This lends credence to Justice Udall's assertion that the majority's approach in *Yeazell* was an inappropriate expression of "judicial will," rather than an outcome rooted in reason and law.[178]

Further, *Thurston* highlights the danger that ill-considered legislative increases in benefits may create for future taxpayers and members—once the legislature enacts a benefit increase, it is constitutionally protected. On the other hand, if the legislature seeks to pass any measure that may result

---

171. *Id.* at 547–48. The court did not conclusively resolve the "vesting" issue as it relates to actual benefits as opposed to benefit formulas. Although the court did acknowledge that Thurston's widow was not vested in the survivor benefit until her husband actually died, it still provided her the higher benefit because of her husband's presumed acceptance of the higher rate. Thus, even though the surviving spouse had no legal right to the benefit at the time the higher benefit was provided, the legislature was still bound to pay the higher rate because the employee was presumed to have accepted it. Thus, the court implies that an employee can be "vested" in a *benefit rate*, even before any person is vested or legally entitled to the *actual benefit*.

172. *Id.* at 547.

173. *Id.* at 548.

174. I note the reliance on a tort case specifically because the treatment of pension benefits as contractual, despite its inconsistency with other aspects of at-will employment, is often justified as being a narrow exception, applicable only to pension cases. Because of this, the reliance on a tort case to analyze a pension issue is arguably questionable.

175. *Thurston*, 876 P.2d at 547 (citing Hall v. A.N.R. Freight Sys., Inc., 717 P.2d 434 (Ariz. 1986)).

176. *Id.*

177. *Compare Thurston*, 876 P.2d at 548, *with* Yeazell v. Copins, 402 P.2d 541, 551 (Ariz. 1965) (Udall, J., dissenting).

178. *Yeazell*, 402 P.2d at 550 (Udall, J., dissenting).

in a diminished or impaired benefit, even indirectly, that change is only valid if the employee *expressly* accepts the modification.[179] Beyond the practical implications, this approach distorts the contract principle of mutual intent by greatly increasing the legislature's burden by implying intent from every statute that may affect pension benefits, while simultaneously making it easier for employees to become legally entitled to additional benefits. This has been described as "heads, I win; tails, the city loses."[180]

Lastly, *Yeazell* and *Thurston* are both inconsistent with a conception of pension benefits as deferred compensation. While the *Yeazell* court argued that "[a] pension is a gratuity only where it is granted for services previously rendered, which at the time they were rendered gave rise to no legal obligation," it estopped the plaintiff from recovering actual compensation paid into the pension fund.[181] *Thurston* also blatantly ignored the deferred compensation analogy and the *Yeazell* court's articulation of why pension benefits are protected.[182] It is difficult to conceive how Judge Thurston, who during his entire employment and at his time of retirement worked under a plan that promised a one-third survivor benefit, still "earned" a two-third benefit for his wife upon his death.

C. *Constitutional Protections*

Along with the broad protection afforded by judicial precedent, public pension benefits in Arizona are protected under the state constitution's Contracts Clause.[183] Article II, section 25 is modeled after the U.S. Constitution's "Contracts Clause" and states "[n]o bill of attainder, ex-post-

---

179. *Thurston*, 876 P.2d at 548. Think of it this way: if a legislature decided to pay plan members a 5% annual COLA benefit, a covered employee need not do anything to be guaranteed a 5% COLA every year of his or her retirement. If, however, the legislature later changes the COLA benefit from a fixed 5% to a formula that ties the COLA to investment performance, even if that formula continues to pay the same or higher formula the majority of the time, if the formula results in the members receiving a COLA less than 5% in any subsequent year, the employee may challenge this as a diminishment or impairment of benefits, *even if* the employee continued to participate in the plan after the change went into effect without complaint.

180. *Yeazell*, 402 P.2d at 551 (Udall, J., dissenting) (quoting Bekenhus v. City of Seattle, 296 P.2d 536, 542 (1956) (Hill, J., dissenting)).

181. *Id.* at 544, 546.

182. *See Thurston*, 876 P.2d at 547 (finding that even if Judge Thurston became vested in a contractual right to have any surviving spouse receive benefits at the time he was hired, the amendment still became a part of his contract and his wife was entitled to the higher benefit because the amendment was beneficial to her).

183. ARIZ. CONST. art. II, § 25.

facto law, or law impairing the obligation of a contract, shall ever be enacted."[184]

Arizona voters amended the state constitution in 1998 with the passage of Proposition 100, thus adding another safeguard for public pension benefits in addition to the state and federal Contracts Clauses.[185] Proposition 100 added Article XXIX, known as the "Retirement" or "Pension Clause," which provides that "[m]embership in a public retirement system is a contractual relationship that is subject to article II, § 25, and public retirement system benefits shall not be diminished or impaired."[186] This provision mirrors the language in the Illinois and New York constitutions, which protect both past and future benefit accruals from diminishment or impairment.[187]

There appears to have been little debate or opposition to Proposition 100, in contrast to Illinois' Pension Clause.[188] One sponsor, Senator Spitzer, indicated that the "intent of the bill is to protect and secure the benefits of the Arizona Retirement System Fund and to prohibit the fund's assets to be used and/or borrowed to subsidize other state programs."[189] Senator Spitzer further stated that "the bill was created to avoid the problem that the State of New Jersey encountered when the State of New Jersey borrowed from their state employees' retirement plan . . . . [E]ssentially the bill prohibits the State of Arizona from 'stealing the assets from the Arizona Retirement System Plan.'"[190]

The "problem" Senator Spitzer referred to was the New Jersey government's chronic habit of failing to pay the annual contribution to pension plans, preferring to use that money elsewhere.[191] As a result, New Jersey had created an overwhelming pension deficit that required the state to take out loans to cover its pension obligations[192] and sparked fears that

184. *Id.*

185. S. Con. Res. 1009, 43d Leg., 2d Reg. Sess. (Ariz. 1998) (referred to by Arizona voters as Proposition 100).

186. ARIZ. CONST. art. XXIX, § 1(C).

187. *See* Robb, *supra* note 69.

188. *See* Ariz. Sec'y of State, 1998 Ballot Propositions, Proposition 100 (July 21, 1998), *available at* http://www.azsos.gov/election/1998/info/pubpamphlet/Prop100.html; Madiar, *supra* note 101, at *14–21; *infra* note 189.

189. Statements taken from Notes on the Committee on Government Operation meeting, 43d Legis., 2d Reg. Sess. (Mar. 18, 1998), *available at* http://www.azleg.gov//FormatDocument.asp?inDoc=/legtext/43leg/2R/comm_min/House/0318.GO.htm&Session_ID=52.

190. *Id.*

191. *See* Richard Pérez-Peña, *Behind Fraud Charges, New Jersey's Deep Crisis*, N.Y. TIMES, Aug. 19, 2010, at A17, *available at* http://www.nytimes.com/2010/08/20/nyregion/20jersey.html.

192. *Id.*

the State would attempt to make drastic reductions to pension benefits to maintain solvency, despite its own culpability in creating the debt. It is important to note, however, that New Jersey follows a property theory of pension benefits (one that Arizona never adopted), which significantly weakens this justification.[193] Although the fear of legislative encroachment on pension benefits, disguised as public necessity, may have been legitimate in other states, Arizona's case precedent and strict contractual approach provided adequate protection against this possibility, even without the addition of Article XXIX.

Arizona's addition of Article XXIX is even more unusual when compared to the circumstance that precipitated Illinois' adoption of its virtually identical clause. Prior to its adoption of its Pension Clause, Illinois treated the majority of its pension benefits as gratuities; in contrast, Arizona had already adopted a contractual approach.[194] In addition, the Illinois legislature had consistently failed to make the required contributions to the state pension funds, leading to chronic underfunding.[195] Indeed, the primary justification for constitutional protection of pension benefits was the failure of the Illinois legislature to "finance the pension obligations on a sound basis."[196] In contrast, Arizona's pension plans historically have been well-funded and the state was, and continues to be, legally required to make the annual actuarial contributions.[197] In 1998, Arizona did not face the same crisis as Illinois in 1970, which makes the addition of Article XXIX even more puzzling.

Given this background, the lack of debate surrounding Arizona's adoption of a Pension Clause implies that the ramifications of constitutionalizing contractual pension benefits were not fully considered.[198]

---

193. *Compare* Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 175 (N.J. 1964), *with* Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965).

194. Prior to the 1970 Constitutional Convention, Illinois treated pension benefits under "mandatory" retirement plans as gratuities, and benefits under "optional" plans as contractual rights with strict protections. Given that fifteen out of seventeen of the state plans were "mandatory" plans at the time, the provision was clearly intended to extend strict contractual protections to those plans as well. Madiar, *supra* note 101, at *6–7; *see generally Yeazell*, 402 P.2d 541.

195. Madiar, *supra* note 101, at *11–12.

196. *Id.* at *12 (internal quotations omitted).

197. *See* ELECTED OFFICIALS' RETIREMENT PLAN SEVENTEENTH COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR FISCAL YEAR ENDED 1998, at 3 ("We are pleased to report that the Plan is in excellent financial and actuarial condition. In fact, the Plan continues to be more than 121% funded.").

198. During the 1970 Illinois Constitutional Convention, the pension clause was vigorously debated. Several delegates argued in opposition to the clause, noting that it would be redundant to include constitutional protection when the Contracts Clause already provided contractual protection for pension benefits. Further, it was argued that the clause would unnecessarily

The addition of Article XXIX prohibits the Legislature from adjusting benefit payments, even those based on surplus funds during times when the fund is inadequate.[199] This is a drastic reduction of legislative power compared to the original 1953 public pension system, where the Legislature expressly reserved the power to modify benefits in response to financial considerations, and illustrates the sweeping consequences of Article XXIX's addition to the state constitution.[200]

VI. REFORMATION ATTEMPTS AND LITIGATION

In 2011, the Arizona Legislature made several changes to the state's retirement plans with the passage of Senate Bills 1609 ("S.B. 1609") and 1614 ("S.B 1614").[201] S.B. 1614 increased the proportionate share of the annual contribution that employees were required to pay into the ASRS.[202] Prior to S.B. 1614, employer-employee contributions were split 50/50; S.B. 1614 increased the employee contribution rate to 53% and reduced the state contribution to 47%.[203] S.B. 1609 made several changes, including (1) altering the retirement age definition; (2) creating new rules addressing pensioners that return to work; (3) requiring forfeiture of pension benefits for convicted felons; (4) increasing the employee contribution rate; (4) limiting early retirement option for new members; and (5) modifying the formula for calculating cost of living increases for the PSPRS, CORP, and EORP.[204]

The S.B. 1614 and 1609 reforms were aimed at reducing the overall cost of the State's retirement plans and specifically targeted several loopholes in the system, such as double-dipping (where a retired employee is rehired and thus receives a pension and a paycheck) and convicted felons remaining eligible for pensions.[205] Despite the good intentions behind the reforms, lawsuits quickly followed.

---

restrict the legislature's ability to modify pension benefits or reorganize and consolidate the pension systems. Madiar, *supra* note 101, at *17, *19.

199. Ariz. Op. Att'y. Gen. No. I09-009, 2009 WL 4100152, at *3 (Nov. 24, 2009).

200. *See supra* Part II note 43.

201. 2011 Ariz. Sess. Laws Ch. 26 (S.B. 1614); 2011 Ariz. Sess. Laws Ch. 357 (S.B. 1609).

202. *See* 2011 Ariz. Sess. Laws Ch. 26 (S.B. 1614).

203. *See* ARIZ. REV. STAT. ANN. § 38-736 (2012); ARIZ. STATE RET. SYS., SUMMARY OF 2011 RETIREMENT LEGISLATION 1 (2011), *available at* https://www.azasrs.gov/sites/default/files/pdf/2011_legislation_summary.pdf. The complete legislation is available at www.azleg.gov.

204. *See* 2011 Ariz. Sess. Laws, 50th Legis., 1st Reg. Sess., ch. 357, 9, 11, 13–15, 30.

205. *See* Craig Harris, *Public Pensions, a Soaring Burden: Some Retired Teachers Rehired While Drawing Pensions, Day 6*, ARIZ. REPUBLIC, Nov. 14, 2010, http://www.azcentral.com/news/articles/arizona-pensions-funds-schools-doubledipping.html;

A. Barnes v. Arizona State Retirement System

Shortly after the Legislature enacted S.B. 1614, state teachers filed a class action lawsuit against the ASRS, arguing that the increase in their contribution rates was an unconstitutional impairment of their contractual right under Arizona's Article II Contracts Clause and a diminishment of their pension benefits in violation of Article XXIX's Pension Clause.[206] All class members were current members of the ASRS at the time S.B. 1614 was enacted.[207]

The *Barnes* plaintiffs prevailed in Maricopa County Superior Court.[208] The court found that increasing the proportionate share of the teachers' contributions from 50% to 53% meant, essentially, that the teachers were paying more money to receive the same benefit, and as such, acted as a diminishment or impairment of their pension benefits in violation of Article XXIX.[209] Further, the court found S.B. 1614 violated the state and federal Contracts Clauses because it "retroactively and unilaterally seeks to substantially change terms of a contract previously agreed to by the parties," namely, the 50% contribution rate for benefits.[210] Although the state argued that increasing the contribution rate served the legitimate public purpose of ensuring the financial security of the plan, the court rejected this argument, finding that "[t]he impairment . . . is substantial, and no significant and legitimate public purpose exists for the breach."[211]

Barnes confirmed Arizona's strict approach to protecting pension benefits and clearly reaffirmed that financial pressure, standing alone, is not a sufficient justification for state modification of public pension benefits.[212] The court acknowledged both Arizona's constitutional provisions and case precedent in striking down the Legislature's attempt to shift some of the cost of its pension plans onto employees, leaving the State little room for

---

Craig Harris, *Public Pensions, a Soaring Burden: Big Pension Costs also a Burden for Other States, Day 7*, ARIZ. REPUBLIC, Nov. 20, 2010, http://www.azcentral.com/news/articles/arizona-pensions-funds-convicted.html.

206. Barnes v. Ariz. State Ret. Sys., CV 2011-011638, at 3 (Ariz. Super. Ct. Maricopa Cnty. Feb. 1, 2012), *available at* http://arnoldfoundation.org/sites/default/files/courtDocs/ARIZONA-Barnes-v-ASRS-Court-Decision.pdf.

207. *Id.* at 2.

208. *Id.* at 4.

209. *Id.* at 3.

210. *Id.*

211. Barnes v. Ariz. State Ret. Sys., CV 2011-011638, at 3 (Ariz. Super. Ct. Maricopa Cnty. Feb. 1, 2012), *available at* http://arnoldfoundation.org/sites/default/files/courtDocs/ARIZONA-Barnes-v-ASRS-Court-Decision.pdf.

212. *Id.*

alternative legal arguments. Following *Barnes*, Arizona Governor Jan Brewer signed House Bill 2264, repealing S.B. 1614 and returning the contribution rate to a 50/50 split.[213]

B. Fields v. Elected Officials' Retirement Plan

After S.B. 1609 went into effect, several retired judges brought a class action suit against the EORP and the State of Arizona, arguing that S.B. 1609's changes to the formula for calculating cost of living adjustments, called Permanent Benefit Increases ("PBIs") in the EORP system, was an unconstitutional diminishment or impairment of their pension benefits.[214] All class members of the lawsuit were retired or retirement-eligible members on the effective date of S.B.1609.[215]

In *Fields*, Plaintiffs noted that PBIs have been included as an additional retirement benefit to retired judges and elected officials under the EORP since 1990.[216] Originally added as a temporary or trial provision, EORP members were entitled to an automatic PBI if the net effective yield of the plan exceeded nine percent.[217] Any benefit increases were capped at 4% of the member's base benefit, and excess funds that were not paid out as PBIs were rolled over into an excess earnings account for future PBIs.

The PBI was set to lapse automatically in 1994 without legislative action, but the Legislature chose to add PBIs as a permanent feature of the EORP in 1996 and expanded the benefits by lowering the age eligibility from sixty-five to fifty-five.[218] The Legislature continued to make periodic reforms and modifications to the PBI, until Arizona voters passed Proposition 100 and removed the Legislature's ability to diminish or impair public pension benefits, even if based on surplus funds, as is the case with the EORP PBIs.[219] Prior to S.B. 1609, the last reform to the EORP PBI was

---

213. ARIZ. STATE RET. SYS., SUMMARY OF 2011 RETIREMENT LEGISLATION, 1 (2011), *available at* https://www.azasrs.gov/sites/default/files/pdf/2011_legislation_summary.pdf.

214. Fields v. Elected Official Ret. Plan, CV 2011-017443, at 1 (Ariz. Super. Ct. Maricopa Cnty. May 21, 2012), *available* at http://arnoldfoundation.org/sites/default/files/courtDocs/ARIZONA-Fields-v-Elected-Official-Retirement-Plan-Arizona-Court-Decision.pdf.

215. *See id.* at 2. It is critical in this particular case that the class consists entirely of retired or retirement-eligible judges, because when a benefit is vested may be different for retired or retirement-eligible members and current or future members.

216. *See* ARIZ. REV. STAT. ANN. § 38-818 (1990); Ariz. Sess. Laws, ch. 236, § 4.

217. 1990 Ariz. Legis. Serv. 236 (West).

218. Laws 1996, ch. 198, § 1, eff. July 20, 1996, retroactively effective to July 1, 1996.

219. ARIZ. CONST. art. XXIX, § 1(c); Ariz. Op. Atty. Gen. No. I09-009, 2009 WL 4100152, at *3 (Nov. 24, 2009).

in 1999 when the Legislature altered the eligibility requirements to make PBI benefits more widely applicable.[220]

S.B. 1609 made two key changes to how PBIs are calculated and paid out. First, S.B. 1609 amended Arizona Revised Statutes section 38-818 to prohibit excess investment earnings over 9% not paid out as PBIs from being transferred to the excess investment earnings account; instead, those funds would remain in the general fund.[221] S.B. 1609 became effective on July 20, 2011, but this change applied retroactively to May 31, 2011.[222]

Second, the bill added Arizona Revised Statutes section 38-818.01 which, starting on July 1, 2013, bases the amount of the annual PBI to the funding ratio of the EORP in that year.[223] Under this section, if the funding ratio is 60% or less, the plan will pay no PBI, and the maximum PBI is capped at 4%.[224] All excess investment earnings over 10.5% will be returned to the general fund.[225]

In *Fields*, Plaintiffs argued that S.B. 1609 was a direct violation of Article XXIX of the Arizona Constitution because of the bill's retroactive prohibition on the rollover to the excess investment earnings fund and the increased "Hurdle" rate that must be used to calculate such excess earnings.[226] Plaintiffs contended that the primary purpose of S.B. 1609 was to diminish or impair their vested contractual rights to a 4% annual PBI based on the pre-S.B. 1609 formula by effectively reducing the frequency and amount of both already earned[227] and future PBIs.[228]

The Maricopa County Superior Court sided with the plaintiff class.[229] Relying on Article XXIX of the Arizona Constitution, the court found that Plaintiffs were fully vested in the future PBIs under Arizona Revised Statutes section 38-818 at the time they retired or became eligible to

---

220. 1999 Ariz. Legis. Serv. ch. 50 (S.B. 1051) (West).

221. *Compare* ARIZ. REV. STAT. ANN. § 38-818, *with* ARIZ. REV. STAT. ANN. § 38-818.03.

222. 2011 Ariz. Sess. Laws, 50th Legis., 1st Reg. Sess., ch. 357.

223. The rates are as follows: for a funding ratio of 60% or less, no PBI; for a funding ratio between 60-65%, PBI increase of 2%; and for each 5% increase in funding ratio over 65%, PBI will increase by 0.5%, with a maximum PBI of 4%. *See* 2011 Ariz. Sess. Laws, 50th Legis., 1st Reg. Sess., ch. 357; ARIZ. REV. STAT. ANN. § 38-818.01(A), (C) (2011).

224. *Id.* § 38-818.01(A), (C).

225. *Id.* § 38-818.01(E).

226. Fields v. Elected Official Ret. Plan, CV 2011-017443, at 1 (Ariz. Super. Ct. Maricopa Cnty. May 21, 2012), *available* at http://arnoldfoundation.org/sites/default/files/courtDocs/ARIZONA-Fields-v-Elected-Official-Retirement-Plan-Arizona-Court-Decision.pdf.

227. The retroactive application of the prohibition on excess investment earnings being kept in the separate excess earnings fund for future means Plaintiffs did not receive a 4% PBI in 2011 that they would otherwise have been entitled to. *Id.*; *see* discussion *infra* Section VII.

228. *See Fields*, Plaintiff's Reply to Defendant's Trial Briefs (on file with author).

229. *Fields*, CV 2011-017443, at 4.

retire.[230] Plaintiffs had received 4% PBIs every year since 1998, and S.B. 1609 would deny them the 4% PBI that would have been paid in 2011 had S.B. 1609 not been enacted, and made the likelihood of future benefits much lower. The court noted, "[t]here is nothing more the Plaintiffs have to do to earn their pension benefits. They have retired; they have fully performed every condition for a benefit."[231]

Because Plaintiffs were held to be fully vested in the PBI established under section 38-818 at the time they retired (prior to the enactment of S.B. 1609), the court found that S.B. 1609 violated Article XXIX's express language prohibiting diminishment or impairment of benefits.[232] Thus, Plaintiffs were not just entitled to *a* PBI, they were entitled to *the* PBI established in section 38-818 prior to the passage of S.B. 1609. Although the Legislature could increase the PBI, S.B. 1609's practical effect was to lower the amount and frequency of future PBIs for the already retired Plaintiffs and thus unconstitutional.[233] The court declined to address whether S.B. 1609 violated either the Arizona or Federal Contracts Clauses, choosing instead to rely entirely on the language preventing diminishment or impairment of benefits.[234]

The State appealed the decision to the Arizona Court of Appeals and subsequently requested a transfer to the Arizona Supreme Court.[235] In a February 2014 opinion, the Arizona Supreme Court sided with Plaintiffs and affirmed the broad protection of Arizona's Pension Clause.[236]

The Arizona Supreme Court reviewed the constitutional challenges *de novo* and, like the superior court, found S.B. 1609 unconstitutional under

---

230. *Id.* at 5. (under ARIZ. REV. STAT. ANN. § 38-818(A), "[a] retired EORP member (or survivor) is entitled to this benefit so long as he or she satisfies one of two conditions [ ]: (1) the member must have been receiving benefits on or before July 31 of the two previous years; or (2) the member must be 55 years of age or older on July 1 of the current year and was receiving benefits on or before July 31of the previous year. If either one of these two conditions are met, the retired member is "entitled" to a permanent base benefit increase as calculated under the provisions of § 38-818"); *see* Madiar, *supra* note 101.

231. *Fields*, CV 2011-017443, at 5.

232. *Id.* at 4–5.

233. *Id.*

234. *Id.* at 6 n.3.

235. Arizona Supreme Court, Civil Transfer Appeal, Fields v. Elected Officials' Ret. Plan (Jan. 8, 2013), *available at* http://apps.supremecourt.az.gov/aacc/appella/ASC%5CCV%5CCV130005.pdf; *see also* Bennett Evan Cooper, Steptoe & Johnson, *Status Report on Pending PSRS Pension-Reform Litigation*, 1, 2 (Nov. 2012), http://www.psprs.com/Admin_Legislation/Legal%20Challenge%20Memorandum.pdf.

236. Fields v. Elected Officials' Ret. Plan, CV-13-0005-T-AP, 2014 WL 644467, at *5 (Ariz. Feb. 20, 2014).

the Pension Clause.[237] In doing so, the Court reached three key conclusions: first, that any analysis of pension benefits must be done under the Pension Clause and not the Contracts Clause, because the "Pension Clause confers additional, independent protection for public retirement benefits separate and distinct from the protection afforded by the Contract Clause"; second, that the statutory formula used to calculate future benefit increases "is itself a 'benefit' protected by the Pension Clause"; and third, that S.B. 1609 diminished Plaintiffs' retirement benefits.[238]

The Court's first conclusion that the Contracts Clause analysis applies only to the general contract provisions of the public retirement plan and not to retirement benefits that the plan provides is not surprising. As the Court notes, applying the Contracts Clause to benefits would render the Pension Clause superfluous.[239] As discussed in Part VII(b)(i) *infra*, while the Pension Clause is arguably superfluous in a practical sense when talking about protecting pension benefits because the Contracts Clause provides ample protection, the Court's interpretation of those clauses is consistent with existing precedent.[240]

The Court's second conclusion is again, not surprising. The Court cites *Yeazell* and *Thurston* when finding that the statutory PBI formula is a "benefit" protected from diminishment or impairment.[241] But the Court also cites the history of the Pension Clause's enactment to conclude that the term "benefit" includes "benefit increases."[242] Because state voters approved the Pension Clause two years after the Legislature removed the sunset provision for PBIs, the Court infers that voters meant to approve "benefit increases in perpetuity."[243]

This inference is weak. First, it assumes that state voters both knew and understood the complicated statutory provisions relating to PBIs. Further, the Court's analysis ignores entirely that there was almost no debate surrounding Proposition 100;[244] inferring the peoples' intent in the absence of dialogue seems shaky at best. Finally, while the Pension Clause did not alter the concept of a "benefit" as it stood under the PBI statute when voters approved the clause,[245] it does not necessarily follow that the clause's failure

237. *Id.*

238. *Id.* at *3, ¶ 16, *5, ¶ 26, *7, ¶ 35.

239. *Id.* at *3, ¶ 16.

240. *See infra* note 284 and accompanying text.

241. Fields v. Elected Officials' Ret. Plan, CV-13-0005-T-AP, 2014 WL 644467, at *5, ¶ 27 (Ariz. Feb. 20, 2014).

242. *Id.* at *5, ¶¶ 22–23.

243. *Id.* at *5, ¶ 23.

244. *See supra* notes 188–90 and accompanying text.

245. *Fields*, 2014 WL 644467, at *5, ¶ 24.

to amend the statute meant voters intended to preserve a *statutory* formula within the state constitution in perpetuity.

The Court did not only rely on legislative history; it also looked to states with similar constitutional provisions (namely New York and Illinois) to determine that the statutory formula is a "benefit" within the meaning of the Pension Clause.[246] While analytically sound, this again raises questions about the necessity of such a strict approach in Arizona. As discussed in Part V(c) *supra*, Arizona's pension experience is much different than those in New York and Illinois.

Once it had established that pension benefit increases are "benefits" within the meaning of the Pension Clause, the Court's third conclusion—that S.B. 1609 diminished those benefits—naturally followed.[247] As the superior court concluded earlier, the Court found that S.B. 1609 had and would reduce members' future PBIs, first by preventing funds from being transferred to the reserve fund and then by making it more difficult to earn future benefits given the increased rate of return required before PBIs would be paid.[248]

The *Fields* decision illustrates the broad protection of Article XXIX—the Legislature no longer has the power to modify cost of living or permanent benefit increase formulas if that modification will result in a retired or retirement-eligible member receiving a reduced or less frequent benefit than the member would have received under the formula at the time of his or her hiring. More importantly, the Court did not even need to reach the Contracts Clause arguments—Article XXIX alone was sufficient to find S.B. 1609 unconstitutional. But, because all of the class members in *Fields* were clearly vested in their retirement benefits, *Fields* did not specifically address when a member vests in a certain PBI formula; or, in other words, whether the Legislature could change the PBI formula for current class members not yet retirement-eligible.

C. Hall v. Elected Officials' Retirement Plan

The Maricopa County Superior Court heard another case in 2013 involving the changes S.B. 1609 made to the EORP.[249] The plaintiffs in *Hall v. Elected Officials' Retirement Plan* are a class of currently sitting judges

246. *Id.* at *6, ¶ 28.

247. *Id.* at *7, ¶ 34.

248. *Id.* at *7, ¶ 35–36.

249. Plaintiff's Motion for Summary Judgment at 1, Hall v. Elected Officials' Ret. Plan, No. CV2011-021234 (Maricopa Cnty. Super. Ct. filed Sept. 21, 2012).

and justices of Arizona's general jurisdiction courts.[250] Unlike the plaintiff class in *Fields*, these judges and justices have not yet retired or reached retirement eligibility, and thus the case is less obvious under Arizona's constitution than *Fields*. Plaintiffs objected to (1) the increase in their contribution rate, similar to the plaintiffs in *Barnes*, and (2) the changed formula for calculating cost of living adjustments, like the plaintiffs in *Fields*.[251] However, this case is somewhat different than *Barnes* and *Fields*, because it addresses what *Fields* left open: what benefits does the contractual relationship between the state and plan members guarantee and, more importantly, *when*? The *Fields* plaintiffs were entitled to the statutory formula for calculating COLAs under the formula that existed when they retired or became eligible to retire.[252] Here, Plaintiffs have yet to retire or become eligible to apply for retirement benefits, so it is arguable that they have not yet "vested" in the particular formula for calculating COLAs that existed when they accepted employment.[253]

This illustrates the difficulty with a strict contractual approach. Arizona finds that the contractual relationship arises once the employee begins work; that is, at the start of the employment relationship.[254] And *Fields* seems to establish that benefits fully vest at retirement or when a member becomes eligible to retire.[255] However, although it is clear that a COLA benefit is covered by the contractual relationship, which arises at the start of employment, it remains unclear exactly when a member vests in the COLA benefit *formula*, rather than just the COLA benefit itself.

Plaintiffs raised three arguments against the constitutionality of S.B. 1609: first, that it violated Article XXIX's Pension Clause; second, that it violated the Arizona Constitution's Article VII, the "Judicial Salary Clause;" and lastly, that it was a violation of both the state and federal Contracts Clauses.[256]

---

250. *Id.* at *1.

251. *Id.* at *1–3.

252. *See Fields*, 2014 WL 644467, at *5–6.

253. In 2000, the legislature enacted a vesting statute applicable to the EORP that provided, in part, that "[a] member of the plan does not have a vested right to benefits under the plan until the member files an application for benefits and is found eligible for those benefits." ARIZ. REV. STAT. ANN. § 38-810.02 (2013).

254. *See, e.g.*, Yeazell v. Copins, 402 P.2d 541, 545 (Ariz. 1965).

255. *See Fields*, 2014 WL 644467, at *5–6.

256. Plaintiff's Response to Defendants' Cross-Motions for Summary Judgment at 10–30, Hall v. Elected Officials' Ret. Plan, No. CV2011-021234 (filed Maricopa Cnty. Super. Ct. Dec. 31, 2012). The plaintiffs also argued that the vesting statute purporting to limit their vesting rights in retirement benefits, *see supra* note 241, was facially unconstitutional under *Yeazell*. Hall v. Elected Officials' Ret. Plan, CV 2011-021234, at 5 (Maricopa Cnty. Super. Ct. Mar. 19, 2013).

The Maricopa County Superior Court agreed with Plaintiffs' argument that they were legally vested in the COLA formula in place at the time of their hiring.[257] The court further found that S.B. 1609 "impermissibly 'diminished or impaired' their benefits," noting that the "Retirement Clause provides greater substantive protections than the Contract Impairment Clause."[258]

VII. ANALYSIS OF ARIZONA'S PENSION PROTECTIONS IN LIGHT OF RECENT LITIGATION

The recent challenges to the State's attempts at pension reforms highlight the fundamental problem with Arizona's pension protection scheme: it is based on a flawed contractual approach. Further, the addition of the Pension Clause to the constitution has allowed the flawed contractual approach to be extended far beyond its original objectives. The evolution of the case law from *Yeazell* to the most recent litigation over pension reforms illustrates how adopting a categorical legal approach to pension benefits to serve policy objectives has created inconsistent results and unnecessarily restricts legislative reform efforts.

The purpose of adopting the contractual approach was to serve two policy objectives: first, to ensure public employees would not be unfairly deprived of their retirement money by the state, and second, to bring the state's pension plans into compliance with the state constitution's Gift Clause.[259] The problem with adopting contractual principles to protect pension benefits, however, is that it does not necessarily serve these policy objectives. Thus, courts often misapply the purported "strict" contract approach to reach the desired objective. This is not only unwarranted

---

257. *Id.* at 3–4.

258. *Id.* at 4. Originally, the court sided with the Defendants on the question of whether the State could statutorily provide that future plan members would not vest in retirement benefits until actual retirement, i.e. whether Arizona Revised Statutes section 38-810.02 was unconstitutional. *Id.* at 5. The court agreed that "because benefits for post-2000 EORP members do not vest until the end of their employment, the Legislature has discretion to modify those benefits until that time." *Id.* However, on a motion for reconsideration, the court found that the legislature could not statutorily alter a member's right to benefits prospectively. *See* Hall v. Elected Officials' Ret. Plan, CV 2011-021234, at 2 (Maricopa Cnty. Super. Ct. July 24, 2013). Instead, the court found that the vesting statute meant only that plan members had no "ordinary" vested right to retirement benefits prior to retirement, but that the statute in no way affected their "legal" vesting rights in those same benefits. *Id.*

259. *Yeazell*, 402 P.2d at 543–45.

judicial activism;[260] it also creates an unhealthy precedent for such activism to continue under the guise of a "strict" contractual approach.

A. Inconsistent Contractual Principles

There are three significant ways in which the Arizona courts' purported strict contractual approach is inconsistent with contract principles generally. First, Arizona's approach does not square with the treatment of pension benefits as "deferred compensation." Second, actually applying a strict contractual approach may result in a lower benefit to an employee, which in turn has encouraged courts to modify the contract approach to accomplish policy objectives. Third, Arizona's approach creates artificial legislative contractual intent, which is not only inconsistent with general contract principles, but also has been expanded far beyond its original purpose.

1. Deferred Compensation

To justify establishing a contract between employees and the State in regards to their public pension benefits, those benefits were categorized as a form of deferred compensation.[261] While this fits neatly with the policy reasons for moving away from a gratuity approach and allows the state to circumvent the Gifts Clause, it has created problems for courts that claim to be applying a strict contractual approach, but instead apply a modified version.

Yeazell shows this inconsistency. The court declared that the employee was entitled to a higher benefit formula under an earlier act, but was nonetheless estopped from recouping the contributions he "overpaid" into the fund under the terms of the subsequent amendment.[262] In other words, the court granted the employee a contractual right to his deferred compensation under the earlier act, but somehow waived his right to recoup *actual* compensation. This is inconsistent with the premise that pension benefits are a form of deferred compensation entitled to contractual protection. Although moving away from a gratuity approach may have been

260. *See Yeazell*, 402 P.2d at 550 (Udall, J., dissenting) ("[T]he majority's decision that the plaintiff was estopped from claiming reimbursement] appears as a mere expression of judicial will . . . . 'Judicial power is never exercised for the purpose of giving effect to the will of the judge.'" (quoting State *ex. rel.* Perry v. District Court of Fourth Judicial Dist., Mont., 400 P.2d 648, 653 (1965)); Cohn, *supra* note 78, at 37, 42 (1968) (Discussing *Yeazell* and noting that "the contract or vested right concept is now being extended, not by legislative judgment but by judicial fiat . . . .").

261. *Yeazell*, 402 P.2d at 543.

262. *Id.* at 546.

necessary to avoid running afoul of the Gift Clause, the purported legal rationale for doing so was inconsistently applied, even at the time of its adoption.

2. Arizona's Strict Contract Approach, Isn't

The second issue with using a contractual approach to serve policy objectives is that if it were literally applied, the contractual approach could result in a lower benefit to the employee.[263] Justice Udall highlighted this issue in his dissenting opinion in *Yeazell*, where he pointed out that by allowing the employee to claim benefits under the earlier act, the employee's surviving spouse would be foreclosed from claiming a higher survivor benefit under the later act if the employee subsequently passed away.[264] In this situation, the contractual approach fails to serve the objective of protecting pensions from diminishment or removal. While a strict approach will protect employees in certain instances, it does not serve their best interests in all situations. In turn, this arguably promotes the judicial activism at play in *Thurston*.[265] *Thurston* embodies exactly the hypothetical that Justice Udall described in his dissent—a situation in which a plan member would actually receive a lower benefit under an earlier act than if he or she had been governed by a subsequent modification. Notably, Justice Udall's dissent is mentioned nowhere in the *Thurston* case. Rather, the court has no problem adapting *Yeazell* to reach the "fair" result—granting the employee's widower a higher survivor benefit provided under the later amendment, although the employee himself had received benefits under the earlier act.[266]

Thurston is a clear illustration of the danger of applying categorical legal labels in an attempt to justify a policy objective.[267] As Rubin Cohn points out in his article *Public Employee Retirement Plans–The Nature of the Employees' Rights*, while the impetus for moving away from the historical gratuity approach may be well-intentioned, "[o]ne is left with a nagging notion that the courts are groping for both principle and rationale without comprehending that the quest will be futile as long as they continue

---

263. *See Yeazell*, 402 P.2d at 551 (Udall, J., dissenting).

264. *Id.* Justice Udall used this to support his proposal for adoption of a system more like California's, in which the state legislature could modify pension benefits so long as any reductions were offset by benefits. *Id.*

265. *Id.* at 550.

266. Thurston v. Judges' Ret. Plan, 876 P.2d 545, 547 (Ariz. 1994).

267. *See* Cohn, *supra* note 78, at 33–34.

routinely and uncritically to apply labels as a substitute for logic and policy."[268]

Viewed in this light, *Thurston* arguably is indicative of judicial activism in the context of public pension litigation. While this is troubling, these cases would not cause undue alarm standing alone. The addition of the Pension Clause to the Arizona Constitution, however, has given these cases a veneer of legitimacy that discourages courts from re-evaluating the reasoning of these earlier analyses. The *Fields* case provides a perfect example—the court relied solely on Article XXIX to reach its decision and consciously ignored the state or federal Contracts Clauses.[269]

3. Artificial Legislative Intent

Generally, in the absence of express intent to create a contract, legislative action like fixing the compensation or terms of state employees does *not* indicate the existence of a contract. Instead, "[t]he presumption is that such a law is not intended to create private contractual or vested rights . . . . He who asserts the creation of a contract with the state . . . has the burden of overcoming the presumption."[270] By adopting a contractual approach and stipulating that the State intends to be bound by its pension promises, the Arizona Supreme Court essentially fabricated legislative intent for all public employees in state retirement plans across the board. The New Jersey Supreme Court in *Spina* refused to do this, stating "[t]he responsibility for creating public contracts is the Legislature's. A commitment of that kind should be so plainly expressed that one cannot doubt the individual legislator understood and intended it."[271] Nonetheless, many states have chosen to carve out an exception to the general presumption against legislative contractual intent in the area of public pension benefits.[272]

---

268. *Id.* at 32.

269. Fields v. Elected Officials' Ret. Plan, CV-13-0005-T-AP, 2014 WL 644467, at *6 n.3 (Ariz. Feb. 20, 2014).

270. Dodge v. Bd. of Educ. of City of Chi., 302 U.S. 74, 79 (1937). "[A]n act merely fixing salaries of officers creates no contract in their favor, and the compensation named may be altered at the will of the Legislature. This is true also of an act fixing the term or tenure of a public officer or an employe [sic] of a state agency." *Id.* at 78–79.

271. Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 176 (N.J. 1964).

272. *See, e.g.*, Kern v. City of Long Beach, 179 P.2d 799, 801 (Cal. 1947); Bender v. Anglin, 60 S.E.2d 756, 760 (Ga. 1950); Bakenhus v. City of Seattle, 296 P.2d 536, 538 (Wash. 1956).

This is problematic because courts no longer have to perform an independent analysis of whether contractual intent exists before applying the attendant protections. While this allows the Legislature to be bound against its intentions, it also means courts no longer have to examine the underlying the rationale for treating pension benefits as a form of deferred compensation. As a result, *Yeazell*'s inconsistent treatment of compensation stands relatively unexamined.

Moreover, *Yeazell* and *Thurston* compound the problem by distorting the requirement of mutual assent in the favor of public employees. As discussed earlier, any beneficial change may be accepted by inference or implication; however, detrimental changes require express acceptance by the employee.[273] Thus, the Legislature's intent to be bound can be implied or inferred from every statute that may affect pension benefits, even indirectly, while employees can become legally entitled to additional benefits by continuing employment, even if their actions indicate otherwise (such as paying a higher contribution rate as required by a subsequent modification without complaint). In sum, the *Yeazell* court created binding intent even where the Legislature did not intend it, and made it easier for employees to reap the benefits of any resulting contract.

This judicially constructed contractual intent means that decisions affecting public pension benefits, whether well-reasoned or not, are binding on the Legislature. Given the multitude of factors beyond the Legislature's control that affect the solvency of its retirement funds,[274] the artificiality of binding the Legislature to any acts that may affect pension plans arguably compromises its ability to maintain the solvency of these plans. Other courts have rejected this artifice of the contractual approach; as New Jersey's highest court opined, "it seems idle to sum up either the public's or the employee's contribution [to pension plans] in one crisp word."[275]

B. Implications of the Pension Clause

The Pension Clause, too, seems to comport with *Yeazell's* policy objectives. On its face, it ensures public employees receive their hard-earned pensions and clearly articulates that membership in a public retirement system is a contractual relationship and thus does not run afoul of the Gift Clause (although this had become relatively unimportant following *Yeazell*). Nonetheless, because it grew out of cases like *Yeazell*

---

273. *See, e.g.*, Thurston v. Judges' Ret. Plan, 876 P.2d 545, 548 (Ariz. 1994).

274. These factors include marriage and mortality rates, investment returns, and longer life spans. *See* discussion *supra* Part II(c).

275. *Spina*, 197 A.2d at 175.

that misapplied contractual principles, it provides a constitutional umbrella under which this flawed protection is perpetuated and may, in the long run, actually harm public employees as a whole.

1. The Pension Clause Compounds the Existing Flaws of the Contractual Approach

The addition of the Pension Clause means that courts no longer have to reconsider the reasoning of cases like *Yeazell* and *Thurston* to reach a result that affords broad protection to public employee benefits, as the *Fields* case shows.[276] Yet the Pension Clause has restricted legislative discretion to a degree not contemplated by the Arizona Supreme Court in *Yeazell v. Copins*, because although the Court did recognize a contractual right to benefits and ban unilateral modification of them, it did *not* imply that no contractual modification of pension benefits was available at all, which is in effect what Article XXIX provides.[277] As a 2009 Arizona Attorney General Opinion highlights:

> Although the Arizona Legislature has made numerous amendments to the System over the more than 50 years of its existence, the Legislature never eliminated ASRS' express right to reduce members' accounts and annuity payments that were derived from surplus funds. Even in 1995, when the Legislature repealed the System statutes entirely, it preserved both System members' rights to surplus and the State's right to reduce accounts and annuity payments that were based on surplus allotments. . . . [T]he voters removed this authority from ASRS upon passage of Proposition 100, which became Article 29 of the Constitution, by prohibiting the 'diminish[ment] or impairment]' of retirement benefits.[278]

More troublesome, however, is the Pension Clause's constitutionalization of artificial legislative intent. Because the clause is not clear as to what "benefit" or "diminishment or impairment" means, the few interpretations of it so far have been broad, thus extending the scope of the clause's protection to include "benefits" that the Legislature was unlikely to predict it would be bound by, much less intend to be locked into. Further, because many vesting questions are still unresolved, the ultimate scope of

---

276. Fields v. Elected Officials' Ret. Plan, CV-13-0005-T-AP, 2014 WL 644467, at *6 n.3 (Ariz. Feb. 20, 2014).

277. *See* Yeazell v. Copins, 402 P.2d 541, 545–46 (Ariz. 1965).

278. Ariz. Op. Att'y. Gen. No. I09-009, 2009 WL 4100152, at *3 (Nov. 24, 2009) (internal citations omitted).

the clause remains unclear. By creating a constitutionally mandated contract without clearly defining the scope of its terms, the Pension Clause impermissibly expands legislative intent. The *Hall* case illustrates these problems—while *Fields* seems to make clear that employees are vested in their retirement benefits once they are retired or eligible to retire, it is less clear both what a current employee vests in (a benefit or the benefit formula) and when (at the beginning of employment or at retirement-eligibility).[279]

Courts could extend the scope of the Pension Clause even further. For example, the courts could conclude that a "benefit" encompasses tax benefits associated with public pensions that Arizona and other states voluntarily provide.[280] In Arizona and states that have constitutional contractual protection for pension benefits, the legislature likely cannot remove these tax exemptions without running afoul of the state constitution.[281] Michigan is the only state with constitutional contractual protection for public pensions that has successfully repealed its tax exemption, but unlike Arizona, Michigan's constitution refers to "accrued benefits," which the Michigan Attorney General relied heavily upon when determining that the repeal was constitution.[282] In Arizona, it appears that the Legislature would be unable to remove the tax exemption without a constitutional amendment.[283] In other words, a pension "benefit" in Arizona can be construed to include the actual pension payment, the statutory formula for calculating the payment, the formula for calculating additional statutory benefits (such as COLAs), the employee's contribution rate, and tax benefits *related to* pension benefits. This potential for expansion of terms by which the state legislature is bound, without inquiry into its underlying contractual intent, makes the Pension Clause appear

---

279. *See* Plaintiff's Motion for Summary Judgment at 11–24, Hall v. Elected Officials' Ret. Plan, No. CV2011-021234 (filed Maricopa Cnty. Super. Ct. Sept. 21, 2012).

280. *See* Raven Merlau, Comment, *The State Giveth and the State Taketh: Constitutional Pension Protections and the Retroactive Removal of Public Pension Tax Exemptions*, 19 GEO. MASON L. REV. 1229, 1249 (2012).

281. *Id.* at 1249–50.

282. *Id.* at 1247–49. In fact, the Arizona Supreme Court distinguished Michigan's constitutional pension benefit language (along with Hawaii's and Alaska's) in the *Fields* decision. *See* Fields v. Elected Officials' Ret. Plan, — P.3d —, 2014 WL 644467, at *6, ¶ 28 (Ariz. S. Ct. Feb. 20, 2014) ("Additionally, unlike narrower protections found in other states' constitutions, the protection afforded by the Arizona Pension Clause extends broadly and unqualifiedly to 'public retirement system benefits,' not merely benefits that have 'accrued' or been 'earned' or 'paid.'") (citing MICH. CONST. art. IX, § 24). Thus, *Fields* provides strong support for this particular hypothesis.

283. *Id.* at 1249.

unreasonably restrictive on legislative discretion and extremely expensive for taxpayers.

2. Arizona is not Illinois or New Jersey

Lastly, history shows that using the Pension Clause to achieve the objective of keeping the state from dipping into pension funds is unnecessary. Arizona case precedent, along with the state and federal Contracts Clauses, provide ample protection without unduly restricting the legislature like the Pension Clause does.[284] Further, as this article illustrates, the addition of the Pension Clause was not justified in Arizona as it was in other states like Illinois that have adopted similar language.[285] Arizona has—and continues to—make its full annual contribution to the funds, but the funding status of the plans continues to drop while the State's annual contribution rises.[286] The Pension Clause is thus addressing a problem that does not exist: while states like Illinois and New Jersey have issues with chronic underfunding, clearly Arizona's pension woes stem from something else—arguably in large part from the Legislature's inability to make corrections to pension plans when actuarial assumptions are off-base or systemic inefficiencies appear.

Some scholars argue that adopting a contract approach is justified to serve policy objectives, which makes arguments that highlight the inconsistency of pension benefits as deferred compensation irrelevant, because that analogy is a means to a "policy" end.[287] However, this argument basically endorses legal labeling, the perils of which are highlighted by numerous scholars and courts.[288] While the goals of its adoption are legitimate, what states are calling a "contractual approach" is generally a hybrid contract and property approach, which distorts settled

---

284. *See, e.g.*, ARIZ. CONST. art. II, § 25; Yeazell v. Copins, 402 P.2d 541, 541 (Ariz. 1965).

285. *See* discussion *supra* Part V(c).

286. *See* discussion *supra* Part II(d).

287. Madiar, *supra* note 76, at 193–94. "[Professor Monahan's] view, however, fundamentally misapprehends (and ignores) why courts use the deferred compensation analogy to protect public benefits as vested contractual rights. The deferred compensation analogy exists as a means to achieve a specific objective . . . . The deferred compensation analogy, in turn, is used by courts as a way to avoid the limitation found in most state constitutions that public servants cannot receive 'gifts' or 'extra compensation' for past services. This fundamental point must be kept firmly in mind. In other words, pension benefits are analogized to deferred compensation as a legal means to hold government employers accountable to the offer they made to employees without running afoul of state constitutional limitations." *Id.*

288. *See, e.g.*, Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 176 (N.J. 1964); Cohn, *supra* note 78, at 32.

contract principles to reach a certain goal.[289] As such, this argument glosses over the inconsistencies between at-will employment and treating pension benefits as deferred compensation because the overall purpose for doing so is valid.[290]

This also ignores the reality of the conflicting role of the State in the pension context. When administering retirement plans, the State must act as an employer, yet the plans are funded largely with taxpayer dollars, so the State must remain cognizant of its role as a sovereign. Labeling pension benefits as contracts may serve one policy, but that policy is often in direct conflict with the State's obligations to taxpayer interests. This further weakens any argument that the ends themselves justify the means.

This argument is also indirectly undermined when one considers that the undue restrictions on pension reform may actually harm public employees in the long run. Given that the policy objective sought by the contract approach is better protection for public pension benefits, then arguably the objective is compromised if a state decides to shift from a defined benefit to a defined contribution model.

By removing the Legislature's ability to modify both past and future pension benefits for members of the plans, Article XXIX forces the Legislature to look for alternative cost-cutting measures in difficult financial times. And while pension benefits are constitutionally protected, there is no such protection for employee salaries, or ultimately their job positions.[291] As such, the Pension Clause may actually harm public employees if the cash-strapped State is forced to reduce salaries, jobs, or lay off workers. More importantly, however, the Pension Clause may be incentivizing a move away from the defined benefit pension plan model entirely. As discussed in Part II *supra*, one of the primary attractions of

---

289. Many states that apply the contractual approach to avoid the Gift Clause still allow the legislature to make reasonable modifications to "maintain the integrity of the system." *Spina*, 197 A.2d at 175. The *Spina* court points out that classifying pension benefits as contractual is not necessary because a state can fulfill a moral obligation or expectancy without violating the Gift Clause. *Spina*, 197 A.2d at 175–76. So, if the contract label is not actually necessary to reach the stated objective, and adoption of the contractual approach is subject to criticism for inconsistency, it is unclear why its adoption is justified on policy grounds.

290. Eric Madiar further argues that "[t]he [deferred compensation] analogy is not invoked to cloak the terms of a public pension plan with the gloss of the employment-at-will doctrine." Madiar, *supra* note 76, at 194. However, adopting a contract theory to public pension benefits gives public employees in states subscribing to the at-will doctrine a "gloss" of contractual employment. When viewed from this angle, Madiar employs the same "faulty" logic as Prof. Monahan by ignoring the inconsistency between the approach chosen and the end result. *See id.* at 193–94.

291. *See* Bennett *ex rel.* Ariz. State Pers. Comm'n v. Beard, 556 P.2d 1137, 1139 (Ariz. Ct. App. 1976).

public employment is access to a defined benefit plan, as they are mostly obsolete in the private sector.[292] By limiting the Legislature's ability to reduce its current defined benefit pension liability, Article XXIX actually encourages the Legislature to examine other options for future hires.[293] In fact, S.B. 1609 itself created a "Defined Contribution and Retirement Study Committee" to research and recommend the viability of moving existing members into defined contribution plans, as well as starting a defined contribution plan for new hires.[294] By making the defined benefit model potentially unsustainable, the Pension Clause encourages the State to abandon one of the crucial advantages public employment offers.[295]

C. Alternative Options for Reform in Arizona

In 2012, the Arizona House of Representatives introduced House Concurrent Resolution 2060 ("H.C.R. 2060"), proposing an amendment to Article XXIX.[296] On its face, this proposed resolution would overrule *Fields*, but more interestingly, it would *only* overrule *Fields*, and not any other cases decided against the 2011 pension reforms to plans other than the EORP.[297] It raises the question of whether this amendment is actually designed to return pension plans to solvency, or if its primary purpose is to target the retirement plan with the least political support, in retaliation for

---

292. *See supra* Part II; Yeazell v. Copins, 402 P.2d 541, 545 (Ariz. 1965) ("Retirement is, as in private industry, a valuable part of the consideration for the entrance into and continuation in public employment.").

293. *See* Michael Barone, *The End of the Defined Benefit*, NAT'L REV. ONLINE (Apr. 25, 2011), http://www.nationalreview.com/articles/265503/end-defined-benefit-michael-barone# (arguing that DB plans rely on assumptions of a "static" society and need to be reformed to reflect today's "dynamic" society).

294. It should be noted that many states are moving towards defined contribution or hybrid plans, even those with "limited vesting" approaches. However, this does not refute that obstacles to pension reform may incentivize a state to do so sooner.

295. In fact, this particular prediction has come true during the publication of this article, at least for elected officials. In June 2013, Governor Jan Brewer signed a bill closing the Elected Officials' Retirement Plan, thus removing access to defined benefits for future employees, and replacing it with a new 401(k)-type plan. *Brewer Signs Elected Officials' Pension Bill*, ARIZ. CAPITOL TIMES (June 20, 2013, 10:16 AM), http://azcapitoltimes.com/news/2013/06/20/brewer-signs-elected-officials-pension-bill/.

296. Ariz. State Legislature, *Bill Status Overview, HCR 2060* (May 2012), http://www.azleg.gov//FormatDocument.asp?inDoc=/legtext/50leg/2r/bills/hcr2060o.asp&Session_ID=107 (last visited Mar. 3, 2013).

297. H.C.R. 2060, 50th Leg., 2d Reg. Sess. (Ariz. 2012), *available at* http://www.azleg.gov/legtext/50leg/2r/bills/hcr2060p.pdf ("For the Elected Officials' Retirement Plan, this section does not prohibit increases in member contributions or reductions in cost of living adjustments consistent with generally accepted actuarial standards and in the interests of the stability of the plan.").

the judicially instituted lawsuits. As Illinois's experience shows, using the state constitution as a political tool is ill-advised and not particularly effective.[298]

On the other hand, a constitutional amendment is perhaps just what Arizona needs. While the scope of H.C.R. 2060 is clearly too narrow to provide much reprieve for a Legislature with few reform options, a constitutional amendment that more carefully delineates exactly which benefits are constitutionally protected is a viable option. Arizona could replicate the language used in Hawaii and Michigan and stipulate that only "accrued" benefits shall not be diminished or impaired. While Arizona courts are likely to interpret this language similarly to Alaskan courts and continue to protect both past and future accruals by finding that an employee vests in their benefits at the beginning of employment, it is still a preferable option to the current scheme, because the Alaskan approach allows the legislature to make reasonable modifications to pension benefits so long as any disadvantage to members is offset by a comparable new advantage.[299] This is similar to the "limited vesting" approach used in California.[300] If a constitutional amendment proves impractical, it is possible that a limited vesting approach could be statutorily authorized instead.

The advantage of taking a limited vesting or accrual approach is that it eliminates the inconsistency that treating pension benefits as "deferred compensation" creates. That is, an accrual approach to vesting is consistent with the theory of at-will employment, to which Arizona subscribes.[301] A strict contractual approach creates inconsistencies when an employee may be terminated at-will, yet is still legally entitled to his or her pension benefit, because this means that an employee who has no legal right to a certain salary or even continued employment nonetheless still has a legal right to the "deferred compensation" that is his or her pension benefit.[302] The accrual approach, then, mitigates the inconsistency that courts have created by labeling pension benefits as "contractual" without examining the underlying ramifications of treating pension benefits as deferred

298. *See* Madiar, *supra* note 101, at *16 ("[T]he [Pension Clause] proposal was intended to 'put the General Assembly on notice that these memberships are enforceable contracts . . . .'").

299. Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981).

300. *See* discussion *supra* Part III(b).

301. ARIZ. REV. STAT. ANN. § 23-1501(A)(2) (2012).

302. Monahan, *supra* note 77, at *30–31. As Professor Amy Monahan aptly puts it, "[h]ow can an individual have a reasonable expectation to future benefit accruals if they cannot have a reasonable expectation regarding the factors that determine the amount of that benefit, such as salary level and length of employment?" *Id.* at *32.

compensation.[303] It has the additional benefit of narrowing the scope of the Pension Clause to help prevent overexpansion of "benefits" and "diminishment or impairment" to include tangential terms that have only an indirect effect on pensioners' payments, like tax exemptions.

VIII. CONCLUSION

Public pension reform has been a perpetually recurring theme virtually since the creation of state-run retirement plans. As the current situation illustrates, absent any fundamental change, the calls for reform will continue. There likely is no perfect "fix" for pension reform given the competing interests of the parties involved, but that does not excuse states from the pursuit of a functional and practical retirement system. However, meaningful pension reform is an exercise in futility in Arizona until lawmakers and voters reduce the strict protections on public pension benefits, either through a constitutional amendment or by otherwise defining an outer limit on what the Pension Clause protects. Arizona lawmakers and voters should seriously consider a constitutional change, because it arguably will serve the best interests of Arizona's public employees and taxpayers in the long run.

303. *Id.* at *34–35. Professor Monahan suggests that a contract theory can protect public benefits without offending other contractual terms, so long as "courts are precise about the duration of the contract." *Id.* at *35.