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Recognizing Pension System Insolvency: A Catalyst for Lasting Reform

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EXECUTIVE SUMMARY

Despite recent stock market highs, Arizona's pension systems remain dead men walking. Officially, the state's major pension funds are 72 percent funded, just 7 percentage points above what the federal government defines as the "red zone," or in critical condition. This means they are short at least $14.5 billion, or $2,300 for every man, woman, and child in the state.

But these official numbers are far rosier than reality. The state's numbers assume pension funds can consistently earn an 8 percent return on investments, a rate of return not seen over the last decade. Based on a more realistic 5 percent rate of return, all of the state's pension funds are in critical condition, with combined unfunded liabilities shooting over $33 billion. That works out to almost $5,000 for every man, woman, and child in the state. And the assumption of a more conservative 10-year Treasury rate would reveal that pension fund insolvency is on the horizon—in 2009, Arizona's funds would have been less than 34 percent funded.

In light of this reality, it is plain that Arizona's pension systems, like those of other states, assume that taxpayers will make up the difference. But developing case law shows there is likely no taxpayer backing for any "independent" pension fund. For this reason, policymakers must enact reforms before the system becomes insolvent.

New employees should be required to join defined contribution plans; old employees should be enticed to do the same. Policymakers should enact a maximum combined contribution rate of no more than 16 percent of an employee's paycheck. To prevent future abuses, state constitutions should be amended to require a legislative supermajority to increase pension benefits. And pension funds should adopt a more realistic rate of return, one that equals or approaches a Treasury rate, to support further benefit and contribution reforms.

At the same time, the 47 states that have constitutional gift clauses should bar pension funds from giving public employees grossly disproportionate compensation for their work. Specifically, to counteract the practice of "spiking," pension benefits for any employee should be capped at an amount that is not grossly disproportionate to that employee's pension contributions. Further, to protect taxpayers from paying multiple times for the same work, pension funds should be prohibited from increasing employer contributions to replenish pension fund losses or to increase benefits for current retirees.

Finally, policymakers should authorize pension funds to file for Chapter 9 bankruptcy. The mere existence of such legislation will encourage trustees and pensioners to voluntarily reform the system. If voluntary reforms fail to materialize, bankruptcy will allow for pension funds to be restructured in an orderly fashion. Such reforms need to begin now to ensure a sustainable and solvent pension system for both taxpayers and employees.

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Arizona's Pension Funds Are in Trouble…

With the Great Recession and subsequent anemic recovery, government revenues remain below their pre-recession levels. Public employee pension systems have become an increasing burden on government budgets at all levels, threatening states' financial solvency. This is a well-known fact among experts around the nation, as reflected in a report from 2012 by the State Budget Crisis Task Force, co-chaired by former Chairman of the Federal Reserve Paul Volcker. That report notes that there are $891 billion of unfunded liabilities in state and local pension systems across the United States, an average unfunded liability of $2,882 for every man, woman, and child in the nation.[1] The Pew Center for the States, in a 2012 report on public sector retirement benefits based on 2010 data, indicates a $757 billion unfunded pension liability nationwide.[2] Regardless of which data point is more accurate, both reflect huge taxpayer liabilities that are likely to grow.

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Arizona is no exception. Using the state's optimistic financial projections, the total unfunded liabilities of Arizona's four major public sector pension systems amount to $14.5 billion. That's $2,300 for every human being in the state. Despite this fact, people claim Arizona's pension systems are sound and among the best managed in the nation. But, by 2004, only two of the pension systems—the Corrections Officers Retirement Plan (CORP) and the Elected Officials Retirement Plan (EORP)—claimed to be more than 100 percent funded. Today, CORP claims only a 68 percent funded ratio. EORP is the worst funded of the four systems, at 58 percent.[3] Moreover, Arizona's pension systems are arguably in deeper trouble than these officially acknowledged numbers indicate.

A Short Primer on Arizona's Pension Systems

Arizona has four major pension systems in which all levels of Arizona government participate, with few exceptions. See Table 1.

Table 1: Arizona's State-Managed Pension Systems

System	Board	Eligible Participants	Membership (Participants)	Employee* Contribution Rate (% payroll)	Taxpayer Contribution Rate (% payroll)
Arizona State Retirement System (ASRS)	Independent Board	All Public Employees Not in the Other Systems	535,501	11.55%	10.25%
Public Safety Personnel Retirement System (PSPRS)	Common PSPRS Board	Police and Firefighters	31,104	8.65%	22.68%
Corrections Officers Retirement Plan (CORP)	Common PSPRS Board	Prison Guards and Officials	19,568	8.41%	9.50%
Elected Officials Retirement Plan (EORP)	Common PSPRS Board	Elected Officials and Judges	1,957	10.00%	32.99%
		Total	588,130		

Source: Retirement Plan Comprehensive Annual Financial Reports

**These are officially reported rates as of the 2012 annual reports. The actual rates reverted to lower levels due to a lawsuit brought by public employees.*

A Retiree's Pension Calculation

Upon retirement, a typical state employee's pension is determined by multiplying his most recent three-year average salary by the number of years that individual worked and contributed toward the system and then by a percentage called a retirement multiplier. Retirement multipliers vary according to length of employment from 2 percent to 2.3 percent in ASRS. PSPRS uses a multiplier of 2.5 percent. So if an ASRS retiree's most recent three-year average salary is $60,000 and he contributed for 30 years, this gives him a multiplier of 2.3 percent.[4] His yearly pension would therefore be: $60,000 x 30 x 0.023 = $41,400. The amount of money needed to provide an annuity for a man with this salary and service history would be about $678,000; the amount for a woman would be approximately $738,000, due to her longer life expectancy.[5]

This type of system pays retirement benefits that often exceed the amount that could possibly be earned from contributions made on a retiree's behalf. Retirement multipliers can be readjusted by the legislature, richening the benefit but doing nothing to enhance the size of the fund from which benefits are paid. For example, rules have changed to allow earlier retirement with higher pensions, even though the system was built with presumptions that careers and contributions would last longer and build a larger fund for benefits. Additionally, pay "spiking" with payouts for unused sick and vacation leave in final work years is still common despite efforts to make the practice illegal.[6] This means past retirement contributions, based on a different earnings trajectory, do not realistically support such retirees' benefits. In other words, some retirees receive far more in benefits than can be justified by the amount of money contributed to the fund in their names, even accounting for investment proceeds.

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Funded Levels and Discount Rates

Ideally a retirement fund, at any given time, would be like a closed mutual fund, which allows an investor to withdraw all his claims without diminishing the claims of anyone else. An ideal pension fund would have assets sufficiently large they would earn enough investment proceeds to completely cover current benefits obligations, including those already earned by employees not yet retired. Assets result from years of contributions made by active employees and employers' (taxpayers') matching contributions to the fund. If investment proceeds exceed benefits paid, they can also add to total assets. Investment losses subtract from total assets.

Pension fund managers must look at more than presently paid benefits compared to current assets, though. This is because some of the assets are intended to support future retirees, not just current retirees. Therefore, actuarial calculations are made to compare current assets to current and future pension obligations already earned. Actuaries must ask if benefits (liabilities to the fund) stopped being earned today, how much money would need to be on hand to cover current pensions and other obligations when they come due in the future? And how does this compare to current assets?

Actuaries answer these questions by taking into account future recipients' expected lifetimes, expected longevity in their jobs, expected career and ending salaries and pensions, and several other employee-based factors. Actuaries must also assume what can be characterized as the fund's expected rate of return on investment or what is technically called a "discount rate." If a person owes someone $100 in 10 years, he could invest some money now so that the initial investment plus earnings would equal $100 in 10 years. The higher the assumed rate of return on that investment, the less he would need to save now. For example, if the debtor thinks he can earn only 5 percent annually, he needs to set aside $61.39 today. If he thinks he can earn 8 percent, he needs to set aside (or have a current liability of) only $46.32 today.

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The choice of discount rate is very important in determining how much current employees and their employers must contribute to the fund and how much in benefits the fund can potentially bear. Currently, ASRS and the PSPRS systems use 8 percent as a discount rate. Until recently, the PSPRS funds used 8.25 percent for their discount rate, but they are transitioning to 7.5 percent. Regardless, these funds have not achieved average rates of return of 8 percent or higher over the last decade. The higher the discount rate, the richer (better funded) a retirement fund will appear because, as the example above shows, the current value of liabilities looks smaller. Also as the example above illustrates, a 5 percent discount rate would value liabilities much higher than an 8 percent rate.

For more information on the funded levels of Arizona's pension systems, see Table 2.

Table 2: Financial Condition of Arizona's Pension Funds 2011 (Dollar Figures in Billions)

	Assets	Official Liabilities	Official Unfunded Liabilities	Official Funded Ratio		Liabilities At 5% Discount Rate	5% Unfunded Liabilities	5% Funded Ratio
ASRS	$28.033	$38.942	($10.909)	72.0%		$54.553	($26.520)	51.4%
PSPRS	$5.048	$9.365	($4.317)	53.9%		$13.608	($8.560)	37.1%
CORP	$1.304	$2.009	($0.705)	64.9%		$3.030	($1.726)	43.0%
EORP	$0.315	$0.590	($0.275)	53.4%		$0.801	($0.486)	39.3%
Totals	$34.700	$50.906	($16.206)	68.2%		$71.992	($37.292)	48.2%

Sources: Arizona's pension plans at the request of Arizona Treasurer Doug Ducey

Pension Funds are in Trouble, Especially if Liabilities Are Properly Calculated (Discounted)…

As has been argued in an earlier Goldwater Institute paper and as noted by the State Budget Crisis Task Force, many experts believe a discount rate commensurate with yields on U.S. Treasury Certificates is more appropriate due to the low-risk guarantee pensions represent for fund recipients, that is, due to the certainty that pensions must be paid.[7] Thirty-year Treasury rates have been falling since the 1980s and are currently less than 4 percent.[8]

Nevertheless, Arizona Treasurer Doug Ducey, who served as chair of the Defined Contribution and Retirement Study Committee as mandated by Senate Bill 1609 in 2011, requested that Arizona's pension funding levels be recalculated using a 5 percent discount rate. Even the arguably high 5 percent discount rate results in a much higher unfunded liability calculation for Arizona—$37.3 billion instead of $16.2 billion, according to Treasurer Ducey's numbers at that time. As demonstrated in Table 2, using the 5 percent discount rate more than doubles the officially recognized unfunded liabilities of the state's pension systems from $2,500 to $5,800 for every man, woman, and child in the state in 2011. Table 3 shows that official liabilities have slightly fallen overall and that the improved fortunes of the stock market have improved the financial picture—for now. Nevertheless, were the funds evaluated at the 5 percent discount rate, unfunded liabilities would still at least double to $29 billion, an amount well over 10 percent of the state's GDP. Using a Treasury rate or even 5 percent would yield a funded level at or below 50 percent. In short, based on a realistic discount rate, Arizona's pension funds are on the precipace of insolvency.

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Table 3: Financial Condition of Arizona's Pension Funds 2012 (Dollar Figures in Billions)

	Assets	Official Liabilities	Official Unfunded Liabilities	Official Funded Ratio
ASRS	$29.230	$38.555	($9.325)	75.8%
PSPRS	$6.052	$10.326	($4.274)	58.6%
CORP	$1.513	$2.232	($0.719)	67.8%
EORP	$0.356	$0.610	($0.254)	58.4%
Totals	$37.151	$51.723	($14.572)	71.8%

Sources: Retirement Plan Comprehensive Annual Financial Reports

In Trouble Despite Increased Taxpayer Funding…

Arizona's pension systems are in serious trouble despite absorbing increasing amounts of taxpayer resources. The systems' annual contribution costs to taxpayers and employees at all levels of state and local government have grown from $477 million in 2000 to $2.4 billion in 2012 (See Chart 1), a 398 percent increase in just 12 years. Contrast this to the relatively modest 65 percent growth in the state's Gross Domestic Product (GDP) from 2000 to 2012. Required contributions to the state's pension systems have grown six times faster than our ability to pay for them.

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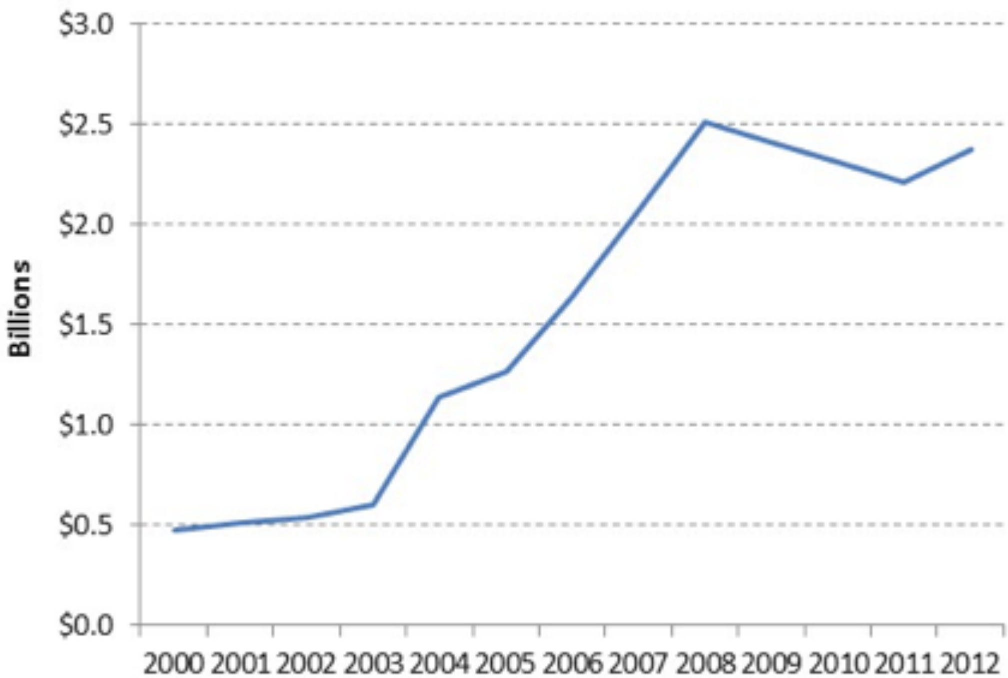
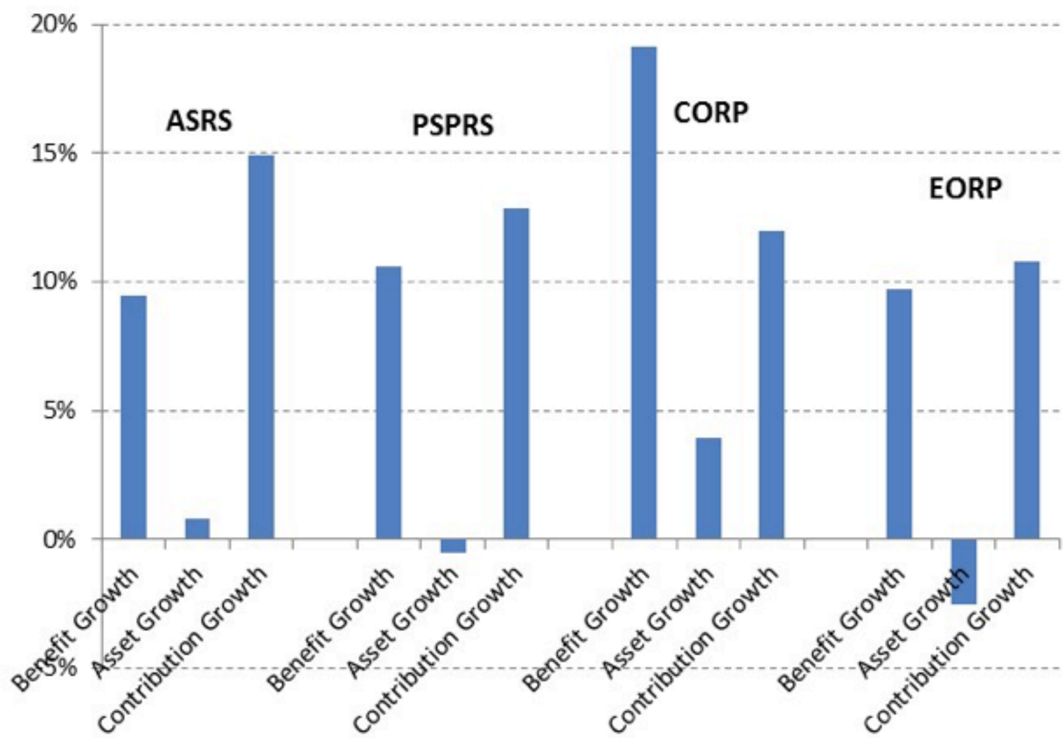
Chart 1: Total Pension Fund Contributions



Source: Arizona pension system Comprehensive Annual Financial Reports

Annual total contributions increased from 2000 through 2012 at average annual rates of between 11 percent and 16 percent per year, depending on the fund (see Chart 2). Annual benefits paid out increased over the same period between 9 percent and 19 percent per year. Assets, on the other hand, grew by an average rate of only 1 percent in ASRS and 4.5 percent in CORP. Total assets in the other two systems actually shrank—by an annual average of 0.3 percent in PSPRS and more than 2 percent annually in EORP. A recent paper from the Cato Institute compared states' pension funding performances from 2001 to 2009 and found that Arizona's performance was third worst among the states.[9] With benefits growing faster than our economy, contributions growing even faster, and assets flat or negative over the last 12 years, it's clear that Arizona's pension systems are unsustainable.

Chart 2: Average Annual Growth Rates of Key Pension Fund Variables: 2000-1012



Sources: Arizona pension system Comprehensive Annual Financial Reports, author calculations

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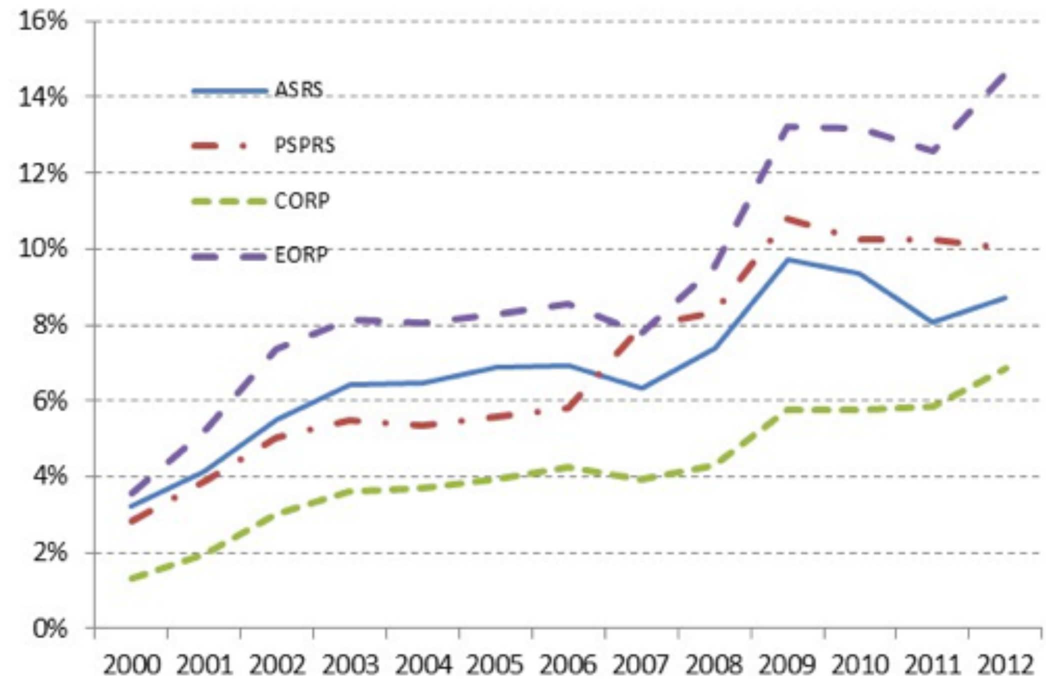
In Trouble Because Pension Funds Keep Losing Ground Compared to Benefits…

One way to judge the health of a pension system is to compare total benefits paid each year to total assets. Chart 3 illustrates this relationship for Arizona's pension funds, taking benefits as a percentage of assets from 2000 through 2012. When this percentage rises, it means assets fell relative to the spending they must support—not a good thing. Note that benefits/assets ratios have increased most dramatically with the recession early in the last decade and the recent recession, when assets fell considerably. Even so, during the 2001-2006 recovery, which was quite healthy and included the housing bubble, the trend of the benefits/assets ratios has been upward despite rising contribution rates.

As Chart 3 illustrates, asset growth has consistently failed to keep up with benefit growth.

Chart 3: Benefits/Assets Ratios



Asset growth has consistently failed to keep up with benefit growth.

Source: Arizona pension system Comprehensive Annual Financial Reports, author calculations

Although this is an oversimplification, a benefits/assets ratio can be thought of as expressing the rate of return that would be necessary to pay current benefits from the investment proceeds of current assets. In 2000, none of Arizona's pension funds would have required more than a 4 percent rate of return in order to pay benefits. Now, however, CORP would require a 7 percent rate of return; ASRS, 8 percent; and PSPRS and EORP, more than 10 and 14 percent respectively. These are rates of return that have not been seen over the last decade and do not appear to be realistically attainable anytime soon, at least not over a 30-year period. In other words, earnings on current pension fund assets cannot hope to support current benefits. The rising benefits/assets ratios are one reason contribution requirements are so high and have been consistently rising for so long.

Trouble Enough That Even More Money Is Needed for Pension Funds…

If Arizona's taxpayers directly paid enough of current benefits to only require each retirement fund to earn a 5 percent rate of return on current assets, it would require a total cash infusion of $1.3 billion. That's a yearly cash infusion of $180 for every man, woman, and child in the state, or the equivalent of more than a penny increase in the sales tax rate. A report published by Harvard's Kennedy School estimates Arizona's unfunded pension liabilities at more than $60 billion, much higher than the estimates made for Treasurer Ducey. The Harvard study estimates Arizona's total state and local taxes would have to have risen 7.4 percent in 2009, a total of $1.5 billion or $608 per household, in order to fully fund the state's pension systems.[10] A 2011 report from the Milken Institute indicates that if Treasury yields are used as a discount rate, Arizona has unfunded pension liabilities of $48.7 billion. This is estimated at 355 percent of the state's total tax revenue and is approximately 20 percent of state GDP.[11]

And Arizona's Cities Help Pay the Price

In 2011, Stockton, California, paid about $116 per capita in pension costs, approximately 21 percent of its general fund revenues. This year, Stockton filed for Chapter 9 bankruptcy. Phoenix and Tucson are not far behind.

In 2011, Stockton, California, paid about $116 per capita in pension costs, approximately 21 percent of its general fund revenues. This year, Stockton filed for Chapter 9 bankruptcy. Phoenix and Tucson are not far behind.

In 2011, Phoenix paid $121.34 per capita in PSPRS and ASRS-equivalent pension costs, about 14 percent of its general revenues, and Tucson paid $127.46, or 18 percent of its general revenues. Neither Phoenix nor Tucson participates in ASRS. The independent retirement funds Phoenix and Tucson maintain were less than 70 percent funded in 2011. These funded ratios are determined using overly optimistic 8 percent discount rates.

While ASRS treats all jurisdictions exactly the same, requiring the same contribution rate as a percentage of payroll for every level of government and all their employees, the other state funds do not. Each fire department, police department, and polity pays a different contribution rate depending on its individual retirement fund financial profile. Some entities pay well over 20 percent of payroll in pension contributions. Others pay modest single-digit percentages. For comparison purposes, Table 3 shows PSPRS and ASRS pension costs in 2011 for select Arizona cities and towns as well as for Stockton, California. Some of Arizona's largest cities face pension burdens approaching that of Stockton.

Table 3: Pension Costs for Select AZ Citites/Towns in 2011

City	Per Capita Pension Costs	Pension Costs % Revenue
Apache Junction	$41.93	11.8%
Avondale	$40.26	11.4%
Buckeye	$29.71	2.9%
Casa Grande	$62.78	12.8%
Chandler	$55.73	6.8%
Flagstaff	$84.64	18.2%
Gilbert	$34.33	7.8%
Glendale	$91.73	12.3%
Goodyear	$58.01	7.9%
Lake Havasu City	$65.79	14.1%
Maricopa	$21.87	5.1%
Mesa	$69.13	15.9%
Oro Valley	$45.76	13.4%
Peoria	$51.99	9.6%
Phoenix	$121.34	14.0%
Prescott	$99.06	11.5%
Scottsdale	$80.45	9.1%
Sedona	$60.90	6.3%
Sierra Vista	$56.09	12.5%
Surprise	$39.14	8.8%
Tempe	$93.72	7.6%
Tucson	$127.46	18.4%
Wickenburg	$58.92	6.4%
Stockton, CA	$115.74	20.8%

Public employees all over the country are guilty of this sort of activity.

Have Government Employees Contributed to the Problem?

If government employees exercise options for which they have actively advocated that weaken the financial integrity of Arizona's pension systems, then the answer to the question above is an emphatic "Yes." If public employees pay little to no attention to the corpus of their retirement funds, assuming that the requirements of retirement formulas will be met, again the answer is "Yes." Indeed, public employees all over the country are guilty of this sort of activity.

Until recent reforms were put in place, Arizona public employees in ASRS could retire under the Rule of 80, a rule adopted long after the pension fund was created. Full pension benefits would be paid to any retiree whose age and years of service summed to 80. This means someone who started work at age 22 could retire at 51 and receive a pension for life, potentially receiving a pension much longer than the 29 years of work. The pension formula would pay 60 percent of salary every year of this hypothetical retirement. Yet, the combined employee/employer contribution as a share of salary would never have exceeded 20 percent and usually would have been much lower. In addition, contributions are based on lower salaries during the retiree's earlier work history. Rule of 80 was put in place when ASRS investments were doing well and future retirees, who were the only ones with an incentive to advocate for it, saw a chance to make a case for a benefit that would allow them to retire early and possibly work elsewhere. In fact, while new employees cannot take advantage of Rule of 80, those who joined the government workforce prior to July 1, 2011, can do so, and the rule continues to weaken the financial viability of ASRS.[12]

DROP (Deferred Retirement Option Plan) also adversely affected PSPRS. DROP allowed a member of PSPRS with 20 years of service to declare an irrevocable intent to retire in five years. During the next five years of service, retirement contributions for that member would cease. Pension payments would be deposited into an account in that member's name. The member would continue to work. At the end of the five years, the member would receive the previous five years of pension payments in one lump sum. This is often characterized as double-dipping since the employee is paid wages while also receiving a pension. It encourages earlier retirement than would otherwise occur; and since DROP was adopted long after PSPRS's creation, PSPRS was not originally structured for this benefit, which in some cases can make a former public employee almost an overnight millionaire.[13]

While the law governing ASRS has prohibited retired members from returning to work until a year after they retire, retirees have participated in double-dipping immediately after retirement. They do this by contracting with a corporation that then contracts with the retiree's former employer to fill the retiree's vacant position.

While the law governing ASRS has prohibited retired members from returning to work until a year after they retire,[14] retirees have participated in double-dipping immediately after retirement. They do this by contracting with a corporation that then contracts with the retiree's former employer to fill the retiree's vacant position. The retiree returns to work for a reduced salary that requires no pension system contributions while simultaneously receiving a pension. The sum of the pension and the salary then significantly exceeds the former salary. Government finances appear better off. The employed retiree is also better off. But the pension system was not constructed to account for such a powerful incentive to retire early.

These practices and that of the city of Phoenix to allow unused sick and vacation leave to inflate salaries on which pensions are calculated (despite a prohibition of this practice in state law[15]), illustrate the inherent corruptibility and fragility of a defined benefit system. Even with the reforms passed in 2011, excuses are made to get around it, and clear abuses have been grandfathered to have impacts for decades to come. A few good years in the stock market could bring all the abuses back when they appear to be "affordable." Yet it is not government employees who bear the consequences of the abuses they help to further. Taxpayers bear the burden.

Have Arizona's Pension Boards Been Irresponsible?

For many years ASRS has used a discount rate of 8 percent. PSPRS, CORP, and EORP have used 8.5 percent and, most recently, 8 percent. Even though these rates are commonly used to value liabilities by pension funds around the country, rates such as 5 percent or the even lower 10- or 30-year Treasury rate should be used. This is because the liabilities, or promised benefits, of pension funds are guaranteed. It is generally believed there is little risk benefits will not be paid. Therefore, they should be supported by assets that have a low-risk, practically guaranteed rate of return. Because pension funds use high discount rates to understate their liabilities, they pursue high and risky rates of return. Given the nature of their liabilities, this strategy is irrational and dangerous—as has been demonstrated by the last recession and the collapse of pension fund assets.

Because pension funds use high discount rates to understate their liabilities, they pursue high and risky rates of return. Given the nature of their liabilities, this strategy is irrational and dangerous, as has been demonstrated by the last recession and the collapse of pension fund assets.

Over its lifetime, ASRS claims a nearly 10 percent average rate of return. In its most recent annual report, however, it claims only a 1.3 percent one-year return. The 10-year rate of return is only 6.3 percent, and the latest one-year rate of return follows two years in a row that suffered double-digit negative returns, an anemic year after that, and then a banner year.[16] It's important to remember how percentages work. Here is a simple example: If you have $100 one year and lose 50 percent, you have $50 left. If in the next year, you make 50 percent on your $50, you only have $75. Negative and positive rates of change do not relate well to each other in comparing absolute changes. What's more, the market has been volatile, and a yearly rate of return can change considerably from one month to another. The long-term rate of return is what matters since a pension fund cannot walk away with winnings after a quick run of good luck.

Since 2000, the pursuit of high rates of return in equities markets has not worked well. In fact, if all of Arizona's state pension funds had invested in very safe instruments since 2000 and earned a rate of return of 3 percent per year, they would be better off by $2.4 billion in assets today.[17] This assumes the same amounts of contributions and benefits as were paid from 2000 through 2011. This additional $2.4 billion in assets would not be nearly enough to fully fund the pension systems, and hindsight is 20/20, but it illustrates that public pension funds in Arizona and around the country are engaging in risky behavior with other peoples' money. They are pursuing high-rate, risky returns to support guaranteed liabilities.

Trouble Down the Road

With the current levels of assets in Arizona's pension funds, bankruptcy for any one fund does not currently appear imminent because they can satisfy their cash flow, and bankruptcy for pension funds seems to be based on cash flow. However, the last 12 years demonstrate that the risk of pension fund bankruptcy is not zero. Despite the marked increase in contribution rates for every fund, contributions currently exceed benefits only in CORP. Benefits are going to continue to increase with the aging of our population and public employee workforce. Many analysts believe the economy is still unstable and overly reliant on artificial stimuli. If our pension funds suffer repeated hits to their assets from ongoing financial crises over the next decade and continued economic struggles see resistance to tax increases to benefit pension funds, one or more could, in fact, go bankrupt. The trend right now is rising liabilities with assets falling and contributions peaking.

Perhaps more likely is the possibility of one or more of Arizona's major cities going bankrupt. Fortunately, few Arizona's cities have the debt load of a Stockton, California. That city borrowed partly to fund its underfunded pensions. In addition, it had promised retirees free health care for the rest of their lives, a contractual promise that could only be broken through bankruptcy. So far, our major cities have not made the major missteps of Stockton. However, pension costs in Tucson and Phoenix are now higher on a per capita basis than in Stockton, and in Tucson, pension costs are nearly as high as Stockton as a percentage of general revenue. Pension fund costs are part of the financial squeeze on all levels of government in Arizona. And if it were a municipality for Chapter 9 bankruptcy purposes, the State of Arizona was essentially bankrupt in 2009 and 2010, when it was borrowing heavily to get by. Another recession on the heels of the last might be enough to put several governments in Arizona into bankruptcy.

Taxpayers cannot be blamed for the current state of affairs. Pension fund boards have been irresponsible. Pension fund managers have been irresponsible. The same irresponsible practices have occurred across the nation, with government pension managers moving herd-like toward a financial cliff.

Taxpayers cannot be blamed for the current state of affairs. Pension fund boards have been irresponsible. Pension fund managers have been irresponsible. The same irresponsible practices have occurred across the nation, with government pension managers moving herd-like toward a financial cliff. But who gets marched off the cliff? The answer, tragically, is taxpayers—taxpayers who often have little more than Social Security to rely on for retirement, who have assumed someone was responsibly guarding their future, who are unaware how poorly pension funds are overseen by those who directly benefit from them. It is taxpayers who are expected to guarantee that beneficiaries receive every penny arbitrary formulas dictate, no matter how badly the beneficiaries might have gamed the system. But that can change if we challenge the premises of the current system.

Contract, What Contract?

The question naturally arises, how did we get to a point that an obviously unsustainable public pension system is regarded as a permanent and inviolate contract for beneficiaries? The short answer in Arizona can be found in Article 29, Section 1, of the state constitution, which declares:

> A. Public retirement systems shall be funded with contributions and investment earnings using actuarial methods and assumptions that are consistent with generally accepted actuarial standards.
> B. The assets of public retirement systems, including investment earnings and contributions, are separate and independent trust funds and shall be invested, administered and distributed as determined by law solely in the interests of the members and beneficiaries of the public retirement systems.
> C. Membership in a public retirement system is a contractual relationship that is subject to article II, section 25, and public retirement system benefits shall not be diminished or impaired.

As a matter of purely textual analysis, Arizona's constitutional guarantee of pension benefits is substantively vague in its meaning. Nothing in the provision dictates the contractual characteristics of the underlying retirement system it references.

At first glance, this provision appears to lock down pension benefits for current members as a matter of contract. The problem with this interpretation is that the provision's wording does not go that far. It actually only guarantees "membership" in a *system* and it only protects the benefits of that *system*. In so doing, it does not guarantee a specific contribution rate, benefit formula, or any benefit amount apart from referencing the pension "system." It provides no clue as to what benefits are entailed by membership in a pension "system," nor whether a system's benefit package is variable or fixed or how contribution responsibilities shall be allocated between employer and employee. Even the use of the passive voice in the phrase "shall be funded" is ambiguous as to who or what has funding responsibility—leaving open the possibility that the system might be funded by employees, employers, the fund itself, the Arizona Legislature, some combination of the foregoing, or all of the above.

As a matter of purely textual analysis, Arizona's constitutional guarantee of pension benefits is substantively vague in its meaning. Nothing in the provision dictates the contractual characteristics of the underlying retirement system it references. But that is clearly *not* the typical understanding of the provision. This necessitates a longer explanation.

The longer answer to "how we got here" is that the entrenchment of our unsustainable pension system reflects the influence of court decisions that have treated current pension benefit formulae as essentially guaranteed by a contract between government employer and employee. Courts have simply held that the benefits offered in a government pension system impliedly become either a property right of the employee upon the first day of work or a contractual obligation of the employer.[18] This is despite the fact that, in the usual case, neither written contracts nor explicit guarantees are made by government employers to their employees regarding pension benefits.

In Arizona, for example, the case of *Yeazell v. Copins*[19] held that a police officer obtained a vested right to pension benefits on the first day of his employment. As explained nearly 40 years later by the Arizona Supreme Court in *Proksa v. Arizona State Schools for the Deaf and the Blind*,[20] the *Yeazell* court reached this decision not because the pension statute contractually bound the state to provide pension benefits in so many words. Rather, according to the *Proksa* court, the *Yeazell* court reached its decision because Arizona's pension system did not expressly bind the state. The *Yeazell* court deemed the pension system statute impliedly "contractual" solely as a consequence of judicial restraint—purely to avoid striking down the legislature's gratuitous pension scheme in violation of the Arizona Constitution's Gift Clause.

Courts have simply held that the benefits offered in a government pension system impliedly become either a property right of the employee upon the first day of work or a contractual obligation of the employer. This is despite the fact that, in the usual case, neither written contracts nor explicit guarantees are made by government employers to their employees regarding pension benefits.

In other words, the *Yeazell* court essentially rewrote Arizona pension law to impose a contractually binding legal obligation on the state. To avoid striking down a statute, which is clearly a legitimate judicial function, the *Yeazell* court instead declared the existence of a new legal right, which is ordinarily not a judicial function. This ruling is a rather ironic application of the doctrine of judicial restraint. A cynic might think that the court's rationale was a mere pretext for reaching a desired outcome. After all, even if judicial restraint required construing Arizona's pension system as contractual in some sense to avoid the constitutional bar of the Gift Clause, it hardly required pension benefits to vest impliedly *on the first day of work* to do so. The Arizona Supreme Court could have instead adopted a rule of vesting upon retirement, as did the U.S. Supreme Court nearly one hundred years earlier in *Pennie v. Reis*.[21]

In any event, as illustrated by *Yeazell*, the cases giving rise to the modern "vested rights" approach to pension benefits do so *despite* the actual statutory language that established the government pension system in question. Regardless of what the underlying pension statute says, this approach contends that an employee supposedly works for the government on the following stipulation—he will take a portion of his compensation for working in a given time frame in the form of wages, and he will take a portion of his compensation for working in that same time frame in the form of "deferred wages," i.e. pension benefit payments, after he retires. Because the payment of pension benefits in accordance with an existing pension system is supposedly earned—or "vested"—as "deferred wages" whenever any work is performed, government employees are deemed to have a contractual property interest in a fixed formula or amount of pension benefits. There are at least three major theoretical problems with this modern "vested rights" approach to pension benefits.

Courts Attacked a Strawman

The "vested rights" approach began by attacking a straw man. In particular, courts in Arizona and elsewhere presented their decision as rejecting an earlier line of cases, which they claimed deemed pension benefits mere "gratuities," like gifts from a king.[22] In fact, no case using a pre-vested-rights approach ever declared that all pension benefits under any circumstance were mere gratuities. Rather, prior cases reasoned that contracts and property rights do not ordinarily arise from benefits conferred by statute. Without definite binding promises of pension benefits, and in view of the at-will nature of the employment relationship, these courts were unwilling to impose the legal fiction of an implied agreement to deferred wages.[23] Instead, they regarded the pre-retirement claim to benefits as a "mere expectancy."[24]

After all, a contract with an employer to be paid a fixed amount of "deferred wages" from a pension system involves the formation of a complex legal relationship of the sort that would ordinarily require a detailed written agreement—a real contract. When public employees and employers form their relationship, few of them know about, much less bargain over, benefits arising from a modern public pension system. In the absence of an actual meeting of the minds on specific terms, courts using the pre-vested rights approach refrained from presuming to impose such a complex relationship on the state and its employees. Far from haughtily deeming a pension benefit "gratuitous," they simply took seriously the underlying reality of the bargain between employer and employee. This observation underscores the second theoretical problem with the modern "vested rights" approach to pension benefits. The assertion of a legal entitlement to pension benefits from "employment day one" is unsupported by the statutory framework of most pension systems, and is contrary to the ordinary rule that statutory benefits do not confer property rights or contractual entitlements.

There is typically no statutory framework justifying the imposition of a "contract" between government employer and employee based on an immutable statutory formula or amount of pension benefits as soon as work begins.

Courts Ignored Statutory Language and Doctrine

There is typically no statutory framework justifying the imposition of a "contract" between government employer and employee based on an immutable statutory formula or amount of pension benefits as soon as work begins. As illustrated by Arizona's various pension systems, instead of giving employees statutory guarantees that they will earn a fixed amount of "deferred compensation" from their *employer (taxpayers)* upon their first day of work, employees are told by the express terms of the law that their pension benefits will be paid solely and directly by a *pension fund* that is an "independent" corporate or "jural" body entirely distinct from both the employer and the state. No promises are made about the performance of that fund. To the contrary, at least one of Arizona's pension statutes expressly disclaims any guarantee that the pension fund will perform as expected.[25]

The statutory framework for Arizona's EORP pension fund even goes so far as to warn that an "elected official has no rights or claims on the plan or this state beyond the capacity of the assets held by the board to provide benefits."[26]

Furthermore, it is common for the law creating a pension system, with Arizona's being just one example, to specifically reserve the right to change any of its terms or conditions at any time. For example, the ASRS pension fund's enabling statutory authority expressly provides: "The right to modify, amend or repeal this article or any provision of this article, is reserved to the legislatures."[27] Similar language qualifies the statutory framework for CORP.[28] Likewise, pension benefit entitlements are typically defined by law in conditional and limited terms—stating there is no entitlement to payment of pension benefits until the employee is eligible for them, and further stating that eligibility arises only upon retirement and only if the employee is not first terminated.[29]

Given the array of statutory contingencies that usually stand between an employee and the receipt of his pension benefits, it seems plain that no reasonable public employee could look at the statutory law that defines his pension benefits and honestly conclude that he was given a contractual promise or a property right by his employer to receive them as "deferred compensation" on his first day of work. Nevertheless, courts still assert that the government employer is, by implication, making that promise. The modern "vested rights" approach to pension benefits is thus unlike the approach taken by courts to any other system of statutory benefits.

Given the array of statutory contingencies that usually stand between an employee and the receipt of his pension benefits, it seems plain that no reasonable public employee could look at the statutory law that defines his pension benefits and honestly conclude that he was given a contractual promise or a property right by his employer to receive them as "deferred compensation" on his first day of work.

Contrary to the modern "vested rights" approach, ordinarily one cannot obtain by mere implication a vested property or contractual right to benefits, legal entitlements, or exclusive privileges created by statute.[30] Courts have long emphasized in nearly every other context that enforceable contracts, promises, and property rights in special benefits or privileges do not arise by mere implication from reliance on a given statutory framework. A toll bridge operator, for example, cannot claim a property right to maintain a toll bridge monopoly in perpetuity just because a law gave him exclusive authority to operate a toll bridge.[31] A business cannot claim a property right to be free from competition based on a law imposing a limited supply of licenses or authorizations to do business.[32] Social Security or welfare recipients cannot claim property rights in their benefits. Courts have also long resisted applying contractual or quasi-contractual legal remedies, such as equitable or promissory estoppel, to enforce apparent promises made by government bodies in the absence of clear legal authority. Instead, there must be specific guarantees made in the law that clearly manifest the enforceability of a genuine legal right.

By disregarding the actual statutory language establishing the rights and obligations associated with pension systems, the modern "vested rights" approach to pension benefits is inconsistent with the entire field of law regarding when a statute creates enforceable property or contractual rights.[33] And yet, the "vested rights" approach imposes an "implied" contractual or property right on pension systems, which verbosely disclaim the existence of any such reliable entitlement. This judicially imposed public policy is a violation of the principle of separation of powers, which is bad enough, but a third theoretical problem arises from it that makes the "vested rights" approach to pension benefits potentially catastrophic to political accountability.

Courts Bargained Away the Political Input of Future Generations

The third theoretical problem with the "vested rights" approach is that liberally recognizing property or contractual rights in benefits that arise from a purely statutory framework threatens the very foundation of our constitutional republic. This is because courts have determined that pension benefits must be paid under the U.S. Constitution's Contracts Clause, and equivalent state constitutional guarantees,[34] regardless of changes in the laws that define the pension system. Ordinarily, however, one legislative body cannot entrench its public policy choices from repeal or alteration by future legislative bodies by enacting mere statutes.[35] Instead, it takes a constitutional amendment to entrench a current legislative body's policy choices from statutory alteration by future bodies.[36] The protection of contractual obligations from impairment under the U.S. Contracts Clause has been ruled an exception to this rule against entrenchment, such that contracts authorized by one legislative body will be held constitutionally binding on future legislative bodies.[37] But courts—in virtually all other contexts—have been careful to say that any such entrenchment applies only to contracts that do not substantially impair the sovereign powers of the state.[38] This limitation on the Contracts Clause exception to the rule against entrenchment is based on the principle that the sovereign powers of the state are held in trust for present and future generations, and the state has no lawful authority to bargain away the powers it holds in trust to the detriment of future generations even when acting in a proprietary capacity as an employer or contractor.[39] To entrench an unsustainable guarantee of pension benefits that was concocted by judicial fiat is an especially grave threat to our representative form of government.

The bottom line is that the modern "vested rights" approach to pension benefits typically gives public employees what they never bargained for and what public employers never promised to give.

The 'Vested Rights' Approach Is Patently Fictitious

Condensing the foregoing analysis, the bottom line is that the modern "vested rights" approach to pension benefits typically gives public employees what they never bargained for and what public employers never promised to give. Further, it judicially entrenches a promise that was never actually made by current legislatures from alteration by future legislatures. This "contractual" arrangement is patently fictitious—even in states like Arizona that constitutionally deem their pension systems as somehow "contractual" without articulating any definite contractual terms. For this reason, pension reform is unsuited to the kind of rigorous judicial scrutiny that has led the Supreme Court to strike down legislative impairments of a state's actual contractual obligations.[40] Instead, pension reforms that are plausibly aimed at protecting the public fisc or protecting future retirees from policies that favor current retirees should warrant judicial deference for exactly the same reason that heightened scrutiny is applied to a legislative impairment of a state's actual contractual obligation—"the State's self-interest is at stake."[41] After all, whenever the legality of pension reforms is tested, it should not be forgotten that state officials—including the judiciary—often have a stake in receiving public pension benefits. This can create a powerful conflict of interest for state officials when it comes to crafting, passing, enforcing, and adjudicating pension reforms. When scrutinizing pension reforms, an impartial judiciary must not place a finger on the scale in favor of their own retirement interests.

Protecting the Public from the 'Vested Rights' Approach

It is already well recognized that the "vested rights" approach to pension benefits does not prevent excluding new hires from an existing pension system and creating incentives for existing hires to voluntarily modify or abandon defined benefit programs, such as by offering promotions or "buy-outs." Where fiscally feasible, this option should be pursued. Additionally, legislatures should consider raising employee contribution rates in light of the Louisiana Supreme Court's recent holding in L*ouisiana Municipal Ass'n v. State*, which distinguished contribution requirements as an independent statutory obligation unconnected with the asserted contractual right to pension benefits.[42] Alternatively, to avoid direct conflict with court decisions that have enforced existing statutory limits on employee contributions as contractually binding,[43] legislatures should enact a maximum combined contribution rate at no greater than 16 percent of an employee's paycheck, which would be based on a generous private-sector retirement plan. These efforts should be pursued whenever possible to reduce the fiscal footprint of defined benefit pension systems. But they are not the only options. The logic of current case law does allow for more creative and potentially impactful reform efforts.

Whenever the legality of pension reforms is tested, it should not be forgotten that state officials—including the judiciary—often have a stake in receiving public pension benefits. This can create a powerful conflict of interest for state officials when it comes to crafting, passing, enforcing, and adjudicating pension reforms.

Reforming Pensions to Protect the Public Fisc

Even under the "vested rights" approach, courts do recognize that vested pension benefits can be divested or impaired by a condition subsequent.[44] In other words, pension benefits can be diminished if the employer reduces salaries or hours, which are the basis of the benefit formula, or if an employee receives retirement income from other sources; also, a vested pension benefit can be lost by an employee who is terminated.[45] Using such precedent, an argument can be made that just as conditions subsequent can divest or impair the "right" to pension benefits when necessary to ensure a workable government employer-employee relationship or to prevent a windfall, so should subsequent events allow for the diminishment of otherwise vested pension benefits—a prime example being the threatened insolvency of the pension system or fiscal calamity for government employers. Such a theory would find support in the reasoning of the Supreme Court case of *Home Bldg. & Loan Ass'n v. Blaisdell*, which tempered enforcement of the Contracts Clause based on the state's need "to safeguard the vital interests of its people."[46]

Reforms that reduce pension benefits to preserve the solvency of a pension system would also find some support in the reasoning of cases that recognize that advantages to beneficiaries as a class may offset any resulting disadvantage to particular retirees. In particular, the California court system—arguably the birthplace of the notion of an implied vested right to pension benefits—has recognized there is implicit flexibility in the vested pension benefit "bargain" to reduce benefits for particular employees, provided that any resulting detriment is offset by a corresponding advantage.[47] Most commonly, this doctrine has been used to support reforms that coupled voluntary promotions with decreases in benefits.[48] But it may also hold the promise for more significant reforms.

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A recent court decision by the Alaska Supreme Court emphasized that in assessing whether advantages from a reform to pension-related health care benefits offset disadvantages, the court must consider the advantages and disadvantages to *all* of the beneficiaries of the pension fund—not just particular individuals currently receiving benefits.[49] The court reasoned that the pension system required such flexibility to remain workable because of constantly changing conditions in health care markets. Although the court otherwise preserved an individualized analysis for pension benefits unrelated to health care on the grounds that the related income streams were more individualized and predictable, increased volatility in the investment markets may warrant reconsideration of that ruling.

If courts can be persuaded to replace their individualized cost-benefit analysis of pension reforms with a group cost-benefit analysis, this would provide a foothold for reforms that would reduce the vested benefits of current retirees to ensure payment to future retirees—if the case can be made that maintaining the status quo would actually threaten payments to future retirees. Afterall, if current benefit levels essentially enable current retirees to dissipate trust assets, maintaining the status quo would violate the contract rights of future retirees even under the modern "vested rights" approach.

However, similar arguments have failed in the past when future retirees failed to prove that the solvency of the pension fund was actually threatened by benefits paid to current retirees.[50] Therefore, it is essential that any pension reform premised on protecting future retirees be supported by an overwhelming legislative record making the case that the solvency of the pension fund is otherwise at stake. It should be possible to make this case once one realizes that the apparent solvency of the typical pension fund for any beneficiary is premised on essentially two things: 1) a discount rate that is much higher than that available for the lowest-risk investments; and 2) employer and taxpayer backing for any fund shortfall. As discussed below, neither one of these premises is reasonable. To the very extent that the pension system maintains such assumptions, gross negligence, if not fiduciary fraud, is being committed. Accordingly, reformers can make a powerful case that reducing current retiree benefits is essential to preserving the solvency of the retirement system for future retirees.

Discount Rates Should Match Treasury Rates

Institutional Investor magazine recently highlighted the vast gulf that separates pension fund philosophies in the United States and the Netherlands.[51] When assessing the present value of their liabilities, pension funds in the United States generally assume a high-flying discount rate of 7 percent to 8 percent, and many were stunned when Indiana recently reduced its assumed discount rate to 6.75 percent to reflect poor investment performance in recent years. By contrast, pension plans in the Netherlands assume a discount rate of 2.42 percent, corresponding to a low-risk, long-term interest rate. The argument for the Netherlands' discount rate is simple: Near-certain pension liabilities should be matched by the assumption of investment in financial securities of the sort that bear near-certain returns. Increasingly, economists and academics in the United States have been questioning why our system deviates from the methodology in the Netherlands.

There is an obvious problem with the actuarial assumption that near-certain pension benefit liabilities will be funded with far-less-than-certain anticipated investment revenues.

There is an obvious problem with the actuarial assumption that near-certain pension benefit liabilities will be funded with far-less-than-certain anticipated investment revenues. After all, to the very extent that courts continue to treat pension benefits as a nearly immutable obligation, pension funds are essentially "betting against the house" when they invest in high-risk financial products and use a correspondingly high rate of return to upwardly adjust the discount rate used in estimating the present value of pension fund liabilities. Moreover, when pension funds set unrealistically high discount rates, they tend to obscure the inadequacy of fund assets to pay future liabilities at current benefit levels. Excessively high discount rates thereby enable current retirees to invade the trust and jeopardize the interests of future retirees.

Because a trustee must treat all beneficiaries equitably, such favoritism for current retirees violates basic principles of trust law—whether one looks to public trust doctrine or to the principles governing private spendthrift trusts.[52] Moreover, disregarding the recent history of massive volatility in the value of pension fund assets and assigning an excessively high discount rate is arguably gross negligence, if not fiduciary fraud, under current precedent.[53]

These observations are relevant to legislative reform efforts because pension funds are not trusts in name only. Arizona's Constitution and pension law, for example, declare that pension funds are trusts to be managed exclusively for the interests of system members and beneficiaries.[54] Board members face personal liability for willful and wanton misconduct and gross negligence.[55] Similar laws govern the pension funds of numerous other states.[56]

This implies that investing in vehicles that deliver a rate of return with a degree of certainty that is commensurate with the supposed legal certainty of pension benefit liabilities is a fiduciary requirement to the very extent that the modern "vested rights" approach to pension benefits is strictly enforced. This means trustees should invest pension assets in the lowest-risk investment products, and pension fund actuaries should assume a discount rate that matches a correspondingly low rate of return.

For this reason, it is entirely reasonable and consistent with the "vested rights" approach to pension benefits to propose legislative reforms requiring pension funds to assume a discount rate that approaches or corresponds to a Treasury rate of return. Simply put, pension fund managers have a fiduciary obligation to assess the health of a pension fund based on a discount rate that corresponds to the rate of return of the lowest-risk investment vehicles—and the legislature has the police power regulatory authority to ensure that fiduciary duty is fulfilled. Moreover, there should be no question about the reasonableness of using Treasury discount rates, because GASB generally allows public pension plans great flexibility in adopting different actuarial methods to determine "accrued liabilities, funding status and other metrics."[57] This conclusion is made all the more emphatic as state pension systems do not enjoy *reliable* employer or taxpayer backing. A reasonable actuary must not assume a higher-discount rate based on the premise that the flow of future employer pension fund contributions will inevitably be sufficiently large to absorb losses from higher-risk investments.

As Chicago Mayor Rahm "the Godfather" Emanuel emphasized during hardnosed bargaining with Illinois teachers unions, there probably is no employer or taxpayer backing for independent public pension funds.

There is No Pension Fund Guarantee

Significantly, the Arizona attorney general has been coy about the nature of the ultimate backing for pension fund benefits—opining in reference to one statewide plan that shortfalls are either "funded through the Plan" or they "would require a legislative appropriation." The phrase "would require" in the future passive voice evokes intentional ambiguity as to whether the attorney general was merely stating a fact about the appropriation process or articulating a legal obligation.[58] Such coyness is understandable.

As Chicago Mayor Rahm "the Godfather" Emanuel emphasized during hardnosed bargaining with Illinois teachers unions, there probably is no employer or taxpayer backing for independent public pension funds.[59] This point was buttressed by the opinion letter of the law firm of Sidley Austin LLP, which concluded that any debt associated with pension benefits ran solely to the funds themselves, without any guarantee by the State of Illinois.[60] The opinion letter itself reflected the reasoning of *Nat'l Foreign Trade Council v. Giannoulias*, in which the court rejected the notion that a state guarantee was implied by Illinois' constitutional declaration that membership in a pension system was "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[61] According to *Giannoulias*, the "independence" of a public pension system renders any such contractual obligation associated with a pension system solely between the beneficiary and the fund—not between the beneficiary and the state or any governmental employer.

Arizona's constitutional provision and laws are similarly drafted (as are those of many other states) and they warrant the same conclusion. In particular, by a constitutional provision almost identical to that of Illinois, each of Arizona's pension funds are deemed independent of the state.[62] Absent some extrinsic guarantee, such independence would imply that there is no backing for pension benefits other than the resources of the pension fund itself. As in Illinois, no such extrinsic guarantee exists in Arizona law. To the contrary, for example, PSPRS' statutory framework underscores "[a]ll payments of benefits as provided for in the system shall be made solely out of the assets of the fund, and the employers, the board and any member of the board are not liable for payment of benefits in any manner."[63] Such language could not be clearer in precluding direct employer and taxpayer backing for pension benefits. In fact, the independent nature of the pension fund system from the state's general fund is one of the reasons courts have sustained the use of fund income to pay increased pension benefits for current retirees—the practice isn't seen as violating Arizona's constitutional ban on extra compensation to state officers because the fund is independent from the state.[64] In Arizona and the half-dozen[65] other states that have similar provisions in their constitutions, this reasoning would seemingly preclude the use of *general fund* money for bailouts of pension funds that have dissipated their assets on risky investments.

While it is true that government employers are obligated by ASRS to make pension fund contributions, this statutory obligation extends only to the "monies of the political subdivision" and is not expressly secured by the taxing power or by any appropriation obligation.

While it is true that government employers are obligated by ASRS to make pension fund contributions, this statutory obligation extends only to the "monies of the political subdivision"[66] and is *not* expressly secured by the taxing power or by any appropriation obligation. In fact, Arizona law expressly warns: "Neither the employers, the board nor any member of the board guarantees the fund . . . in any manner against loss or depreciation."[67] The only security that exists for the payment of employer contributions to the ASRS is the broad power given to the board to levy on the employer's *assets* to pay pension fund obligations. In view of this express grant of power to levy on *assets* of a "debtor" to recover "moneys owed,"[68] but *not* the power to compel a *tax* levy, the most reasonable interpretation is that such language was intended to preclude the contractual right to compel government employers to raise taxes or make appropriations to meet pension obligations. This is based on the constructional rule that the inclusion of a specific term precludes all other terms.

Furthermore, even if employer contribution obligations to the pension fund were somehow found to be backed by the taxing power, there is no inherent guarantee that employers must make up for investment losses. Instead, where an employer's contribution is based on a certain percentage of employee compensation or a "projected unit credit" formula for a particular *pay period*, as in the case of ASRS,[69] this should imply that any contribution obligation is limited to the pay period in which it originally accrued. If the value of the employer's original contribution in a given pay period is later lost on risky investments, government employers would still have no obligation to replenish the fund.[70] It is tantamount to paying twice for the same work when employers pay extra to make up for such losses. As discussed in greater detail below, to the very extent that the employer's initial contribution was "deferred compensation" for work already performed, Arizona's Gift Clause, which bars expenditures of public money for nothing in exchange, stands against essentially paying twice (or more so) for the same work even if a public purpose is served.[71]

Although political pressure has resulted in public employers making regular contributions to pension funds, and threatens to induce public employers to raise taxes to make those contributions, the legal reality is often that there is no clear guarantee of taxpayer backing if public employers balk.

In short, although political pressure has resulted in public employers making regular contributions to pension funds, and threatens to induce public employers to raise taxes to make those contributions, the legal reality is often that there is no clear guarantee of taxpayer backing if public employers balk. Indeed, the Supreme Court and courts in Arizona and elsewhere have long ruled that principles of separation of powers may preclude courts from assuming a quintessentially legislative role and decreeing that taxes be raised and appropriations be made to pay debts contrary to, or in the absence of, express legal authority to do so.[72] Although this previously bright line rule has been eroded,[73] courts are unlikely to disregard statutory language that expressly or by necessary implication denies employer and taxpayer backing for pension benefits at the time the debt was incurred.

Therefore, if existing tax revenues preclude public employers from meeting contribution demands, and push comes to shove, investment losses must fall on fund beneficiaries. While public employers have *liability* for making contributions to the fund, there is no *guarantee* that taxes will be raised or diverted from essential services to fund those contributions. Yes, the promises of a public employee pension system are often viewed as contractual. But the laws creating "independent" pension fund systems expressly and, in the absence of language to the contrary, by necessary implication disclaim any guarantee by the state or any public employer that the fund will perform as promised. This point of law reveals the manifest imprudence of premising the solvency of public pension systems on high-flying rates of return. A risky investment plan by pension fund trustees could leave future retirees penniless because there is no reliable guarantee that the value of lost contributions will be made whole by the employer, much less the taxpayers or the state.

Recognizing Insolvency as an Impetus to Reform

The assumption of a Treasury-based discount rate would likely reveal that future retirees are threatened with fund insolvency by any acceptable measure of assets to liabilities. For example, if the discount rate used to determine asset-to-liability ratios in Arizona were based on ten year Treasury rates, then, as of 2009, Arizona's actuarial asset value would have been less than 34 percent of liabilities.[74] Because a pension fund is regarded as poorly funded when actuarial asset values are less than 60 percent of liabilities,[75] recognizing a Treasury-based discount rate would reveal the reality that every dollar paid to current retirees under the status quo pension benefit scheme would threaten benefits of future retirees. Thus, once legislative reform replaces the arguably grossly negligent use of excessively high discount rates with a Treasury rate, it should become immediately apparent the typical pension fund is insolvent; and, therefore, maintaining current benefit payouts is structurally biased in favor of current retirees at the expense of future retirees.

This is an intolerable situation for a trust that is operated by trustees who owe a fiduciary duty to both current and future retirees. Looking at the advantages and disadvantages to the beneficiary class as a whole, and recognizing that there is no clear case for employer or taxpayer backing of fund shortfalls, it is entirely possible that courts would embrace a legislative reform that proportionately reduces current retiree benefits to ensure a solvent system for future retirees if that reform is premised on a Treasury discount rate. After all, if actuarial soundness for future retirees cannot be maintained without reducing current retiree benefits, then the advantages of the reforms for future retirees will necessarily offset the disadvantages to current retirees.

Forty-seven states have constitutional "Gift Clauses" that prohibit government from subsidizing private interests with public money. Sadly, until recently, Gift Clauses had done little to prevent gifts of public money through elaborate pension schemes.

Deploy the Gift Clause

Reformers have another card to play. Forty-seven states have constitutional "Gift Clauses" that prohibit government from subsidizing private interests with public money.[76] Sadly, until recently, Gift Clauses had done little to prevent gifts of public money through elaborate pension schemes. In Arizona, for example, past Gift Clause-based challenges to pension benefit programs were rebuffed by court decisions that applied a test that would sustain any benefit program so long as it was regarded as serving a public purpose—and the goal of enhancing the desirability of public employment for future hires was always deemed a sufficient public purpose.[77] But there is good reason this case law would not be followed today.

In the 2010 case of *Turken v. Gordon*, the Arizona Supreme Court held, "when government payment is grossly disproportionate to what is received in return, the payment violates the Gift Clause."[78] No longer is proof of a public purpose alone sufficient to withstand a Gift Clause challenge. Instead, unlike the test applied in all prior cases rejecting Gift Clause challenges to pension benefit schemes, the current test requires *both* a public purpose *and* proof that a gift of public money was not made. As discussed below, *Turken's* revised two-part Gift Clause test is likely failed by: (1) any increased employer contribution requirement that essentially forces an employer to pay multiple times for the same work; and (2) pension fund payouts to employees that are grossly disproportionate to the reasonable value of contributions attributable to them over their respective careers.

An unconstitutional gift of public money would occur whenever investment losses by an independent pension fund bring about increases in employer contributions. It would also occur whenever pension benefit increases to *current* retirees require increases in employer contributions. The same is true if increases in employer contributions are sought to remedy past financial mismanagement of an independent pension fund, such as to restore a fund to solvency after it replaces an excessively high discount rate with one that is more realistic. This is because employer contributions are conceptualized as deferred compensation for work already performed. Once an employer contributes to the pension fund based on a past pay period, it has already furnished the employee with full compensation for his work. The employer is not legally responsible for the fund's handling of its contribution because the fund is independent from the employer. If that money is later lost by the fund, or if that money is used to pay additional benefits to current retirees, or if that money proves to be inadequate due to financial mismanagement of the fund (such as picking an excessively high discount rate), any increase in the employer's contribution rate to replace it would, in substance, be a public expenditure for nothing in exchange. Under *Turken*, a public employer would be constitutionally prohibited from making that expenditure because giving something for nothing is "grossly disproportionate to what is received in return."

Once an employer contributes to the pension fund based on a past pay period, it has already furnished the employee with full compensation for his work. The employer is not legally responsible for the fund's handling of its contribution because the fund is independent from the employer.

Additionally, although pension systems like Arizona's base the amount of a pension payout on an average of the retiree's salary for her last three years of service, it is important to underscore that this baseline is not a true measure of the value exchanged by the employee for his pension benefits. As pension benefits represent the payment of previously deferred compensation for work performed from "employment day 1," the actual value exchanged by a retired employee for his pension benefits is the reasonable value of the sum of that deferred compensation. Rather than being based on the average of the retiree's salary for her last three years of service, this amount would be the sum of contributions to the fund attributable to that employee adjusted upward by a reasonable rate of return attributable to the lowest-risk investment vehicles, such as 10- or 30-year Treasury rate, over the span of the employee's entire career (to account for the opportunity cost of deferring such compensation[79]). Accordingly, the second prong of *Turken's* Gift Clause test would bar the present value of pension benefits for an employee at retirement (assuming an appropriate life expectancy) from being grossly disproportionate to this sum. Undoubtedly, what is "grossly disproportionate" would be fairly debatable. But certainly a debate would begin once the present value of pension benefits for any employee at retirement exceeds 125 percent of the sum of his contributions to the fund after they are adjusted upward by a reasonable rate of return—a scenario that indeed happens in the worst examples of end-of-career income "spiking."[80]

In view of *Turken*, policymakers should protect taxpayers and core services by enacting legislation that: (1) bars public employers from paying any increase in their contribution rate that is attributable to the replenishment of pension funds due to investment losses, increases in benefits to current retirees, or financial mismanagement; and (2) caps the present value of pension benefits for any employee at retirement at no more than 125 percent of the sum of contributions to the fund attributable to that employee after the sum is adjusted upward by a reasonable rate of return over the span of the employee's career (the law should require pension fund managers to adjust the stream of pension fund payouts accordingly). Even in the absence of statewide legislation, public employers should resist any increase in their contribution rates that is attributable to the payment of grossly disproportionate compensation to employees. Such resistance should be advanced through appropriate legal action, if necessary—either directly by employer representatives or by citizens through taxpayer standing. Because there is no direct taxpayer backing for an independent pension fund, a victory will force courts to fashion an equitable remedy that involves either pension benefit reductions or employee contribution rate increases. Either way, the taxpayer and core governmental services should win a measure of pension reform.

States should enact legislation authorizing state-based pension funds to file for bankruptcy under Chapter 9 of the Bankruptcy Code if necessary to return a pension fund to solvency.

Prepare for Chapter 9 Bankruptcy

Nevertheless, legislative action may not be forthcoming in light of the challenging political dynamics it would entail.[81] Moreover, just as courts have blocked numerous legislative reforms aimed at shoring up the solvency of pension funds based on other theories, it is possible that judicial intervention will cause the foregoing tactics to fail. This could leave a pension system trapped in a state of insolvency—unable to reduce pension benefits, unable to force government employers or the state to raise taxes to increase contributions, and also unable to increase employee contributions. Under such circumstances, policymakers will wish they had an alternative means of reducing the obligations of the pension fund to sustainable levels. In fact, they have one.

States should enact legislation authorizing state-based pension funds to file for bankruptcy under Chapter 9 of the Bankruptcy Code[82] if necessary to return a pension fund to solvency.[83] There are five requirements for a pension fund to qualify for Chapter 9 bankruptcy protection: 1) it must fit the statutory definition of a "municipality;" 2) it must be insolvent; 3) it must propose and be willing to accept a debt adjustment plan; 4) it must be authorized by statute to seek bankruptcy protection; and 5) it must engage in good faith negotiations with creditors prior to filing the petition.[84] If it met these requirements, an insolvent pension fund could benefit immensely from filing for bankruptcy because the obligation to pay pension benefits would be regarded as a general unsecured debt of the fund.[85] Thus, if proposed by the pension-fund-petitioner in its plan,[86] the bankruptcy court would have broad authority to sidestep the modern "vested rights" approach. This is because state laws establishing the pension benefit "contract" are preempted by the Bankruptcy Code, and Chapter 9 courts are not required to observe state law in managing the property of the bankruptcy estate.[87] Thus, despite recent court action attempting to block Detroit from filing for bankrupcy, efforts in state law to frustrate the debt adjustment powers of a Chapter 9 bankruptcy court should fail.[88]

In principle, as with any other general unsecured debt, a bankruptcy court could completely restructure and reduce, i.e. "cram down," pension benefit payments to ensure the solvency of the fund for current and future beneficiaries.[89] And while the petitioner develops the plan, and the bankruptcy court works to confirm the plan, the pension-fund-petitioner could preserve its assets from dissipation by virtue of the automatic stay on creditor claims that would be triggered by filing for bankruptcy.[90]

Chapter 9 Bankruptcy offers a powerful framework for reforming a statewide pension system that is threatened with insolvency by the modern "vested rights" approach to benefits.

As such, Chapter 9 Bankruptcy offers a powerful framework for reforming a statewide pension system that is threatened with insolvency by the modern "vested rights" approach to benefits. In the case of *In re City of Prichard*, Alabama, for example, in exchange for a $16.5 million cash infusion, the bankruptcy plan ultimately reduced all existing and future pension benefit payments by 8.5 percent, denied future pension increases for current retirees based on employee wage increases, and reserved the right to seek further benefit reductions as needed to ensure the solvency of the plan.[91] This is precisely the kind of reform that could save public pension funds in Arizona and across the nation. Fortunately, independent state-based pension funds meet all of the requisites for filing Chapter 9 bankruptcy.

The Typical Pension Fund is a Chapter 9 Municipality

Chapter 9 defines a "municipality" as a "political subdivision or public agency or instrumentality of a state." This definition was first invoked by Congress in an amendment to Chapter 9 in 1975, which declared: "[a]ny State's political subdivision or public agency or instrumentality, which is generally authorized to file a petition under this chapter by the legislature, or by a governmental officer or organization empowered by State law to authorize the filing of a petition, is eligible for relief under this chapter."[92] Three years later, in 1978, the definition of "municipality" was amended to reflect this earlier change in the code.[93] As explained in the 1975 Report of the House Judiciary Committee, Congress' intention in referring to "[a]ny State's political subdivision or public agency or instrumentality" was "to broaden the applicability of Chapter IX as much as possible."[94]

Among the three categories that define "municipality," the most naturally applicable to a statewide pension fund would be "instrumentality of a state." The term "instrumentality" means "the quality or state of being instrumental,"[95] and there is no doubt that pension funds are "instrumental" to a state. Such common usage of the term "instrumentality" also reflects the legal use of the term in numerous cases in contexts that refer to public pension funds as "instrumentalities" of the governmental unit that created them.[96] Significantly, at least two cases have specifically described public pension funds as "instrumentalities" of a state.[97] In view of the longstanding rule that the Bankruptcy Code, as a remedial statute, must be liberally construed "with any fair construction that can be put upon it,"[98] the foregoing usages constitute a fair basis for regarding an independent public pension fund to be a "municipality" for purposes of Chapter 9"—especially in light of the purpose of the definition to broaden Chapter 9's applicability "as much as possible."

Nevertheless, what entities constitute a Chapter 9 municipality can be controversial and the subject of extensive litigation. There is some authority for opponents to challenge the ability of pension funds to qualify as a Chapter 9 municipality. In the case of *In re County of Orange*, for example, the court rejected attempts to classify an investment fund created by the *county* as a municipality. The court, however, did so on the basis that the law was ambiguous as to the proper classification of an investment fund; that earlier versions of the code did not reference similar entities as falling within the definition of "municipality"; and that an "instrumentality of a county" was not equivalent to an "instrumentality of a state" because Congress did make reference to county instrumentalities in another part of the code and presumably chose not to include the term in the definition of municipality.[99]

Not surprisingly, it has long been held that the test for whether an entity was eligible for Chapter 9 was "whether the authority or agency is subject to control by public authority, state or municipal."

County of Orange, however, failed to recognize that there is no viable distinction between municipally created entities and state-created entities for purposes of Chapter 9 eligibility—the original list of taxing authorities promulgated in the 1930s and 1940s included a number of special districts that would have been created directly by municipalities. Not surprisingly, it has long been held that the test for whether an entity was eligible for Chapter 9 was "whether the authority or agency is subject to control by public authority, state or *municipal*."[100]

Furthermore, the amendment history of Chapter 9's definition of "municipality" reflects a continuous attempt to expand the definition to encompass ever more exotic governmental entities beyond the original list of municipalities that qualified for bankruptcy in the 1930s and early 1940s, which comprised solely local taxing authorities.[101] Consequently, an entity's possession of traditional governmental powers, such as the taxing power, is no longer the *sine qua non* of the definition of "municipality." Instead, as reported in the Congressional Record after the adoption of one of the more recent amendments, the current definition of municipality—which encompasses all political subdivisions, public agencies and instrumentalities of the state—was adopted to ensure it would be applied as broadly as possible to allow governmental units liberal access to Chapter 9 bankruptcy.

In view of this analysis, the leading test for whether an entity is a "municipality" that can qualify for Chapter 9 bankruptcy involves assessing three factors: (1) "the extent to which the entity has traditional governmental attributes or engages in traditional governmental functions;" (2) the extent to which the state controls the entity's operations; and (3) the extent to which the state itself categorizes the entity as a municipality or instrumentality. If an entity has traditional governmental attributes or functions, it will usually be regarded as a "municipality."[102] If not, then the second two factors will control the determination, with direct political control over an entity by state officials being almost conclusive proof that the entity qualifies as an "instrumentality of the state."[103]

Applying this test, an independent pension fund, such as Arizona's ASRS, PSPRS, EORP, and CORP, would almost certainly qualify as a "municipality" in the sense of being an "instrumentality of the state" under Chapter 9.

Applying this test, an independent pension fund, such as Arizona's ASRS, PSPRS, EORP, and CORP, would almost certainly qualify as a "municipality" in the sense of being an "instrumentality of the state" under Chapter 9. First, although the state itself cannot file for Chapter 9 bankruptcy, there is little doubt that an independent pension fund would be regarded as a distinct legal entity from the state itself, akin to a municipal corporation.[104] In Arizona, for example, constitutional and statutory law deems pension funds jural and independent entities, with corporate powers and privileges.[105] ASRS requires the establishment of a depository that is "separate and apart from all other public monies or funds of this state."[106] PSPRS declares that it is "not under the jurisdiction of the department of administration or any other agency, department or instrumentality of this state."[107] Second, these funds are directly created by Arizona state law and thus naturally regarded as an instrumentality of the *state* rather than an instrumentality of a political subdivision, such as a county. Third, there is no doubt they are controlled by the state, not merely regulated by it. The members of their governing boards of trustees are appointed by the governor of the State of Arizona.[108] Necessary funding for pension plan business operations is also "continuously appropriated" by the Arizona Legislature.[109] Fourth, there is no question the pension fund serves a public function consisting of operating the pension systems of state and local government for government employees. Any fund that shares these characteristics clearly would fit the "instrumentality of the state" component of the definition of a municipality under Chapter 9.

A Pension Fund's Assets and Liabilities Are Part of the Bankruptcy Estate

Even if a public pension fund qualifies as a municipality that is eligible for Chapter 9 bankruptcy, another question is whether the assets and liabilities of a pension fund comprise an "estate" that can be adjusted by the bankruptcy court. Ordinarily, the estate of a bankrupt entity only includes assets and liabilities that are completely owned by and attributable to that entity. A pension fund, like any trust arrangement, presents an unusual situation in which the assets it holds are not entirely owned by the trust but are held for beneficiaries, with ownership of the assets essentially divided between the two in the eyes of the law (the trust holds "legal" title, and the beneficiary holds "equitable" title). Similarly, the liabilities of the trust are not necessarily claims against the trust itself, but only against the assets that it is holding, which the court has the duty to respect.

In view of these defining characteristics of a trust arrangement, an argument could be made that a pension fund really has no estate of its own that can be brought within the jurisdiction of the bankruptcy court.[110] This argument would be based on 11 U.S.C.S. § 541(d), which excludes from the estate property "in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest." This argument would be mistaken, however, because this provision was only intended to apply to "donative trusts" in which one or more segregated and identifiable assets are being held for one or more specified beneficiaries.[111] Unlike a donative trust, there is no way to attribute a specific liability for pension benefits for a specific beneficiary to a specific asset held by a typical public pension fund—the assets and accrued investment income are undifferentiated between beneficiaries. Moreover, trustees of a typical independent public pension fund are in a position to exercise complete dominion over the assets and accrued income for investment purposes, business operations, and also to pay outstanding benefits.

Just like any other business trust's assets and liabilities, the assets and liabilities of a public pension fund are quite properly regarded as part of the bankruptcy estate.

Like the trustees of the business trust in *Cutler v. The 65 Security Plan*, pension fund trustees are "doing more than simply holding and preserving assets . . . [t]hey, in fact, control multibillion dollar businesses . . . [l]arge numbers of employees are required to run the enterprise . . . hundreds of thousands of claimants are in the position of stockholders receiving dividends on their claims . . . [i]n addition to investment concerns, the trustees are involved with such typically corporate notions as governance, productivity and public relations . . . [i]ts aim is financial gain" and its "transactions are of the nature typified as doing business."[112] Therefore, in substance, the typical independent public pension fund is in the same position of control and responsibility *vis-à-vis* its assets and liabilities as any business trust *vis-à-vis* its assets and liabilities. Just like trustees of a business trust, trustees of an independent public pension fund act as if they have both legal and equitable title to fund assets. For this reason, just like any other business trust's assets and liabilities, the assets and liabilities of a public pension fund are quite properly regarded as part of the bankruptcy estate.[113]

A Pension Fund Is a Chapter 9 Debtor

A related question is whether a pension fund is a "debtor" and, correspondingly, whether the obligation to pay benefits to the beneficiaries of a pension fund are "debts" subject to adjustment if the pension fund files for bankruptcy. The answer to this question is made relatively easy by the broad definition of "debtor" and "debt" in the code, which is "[t]he term 'debt' means liability on a claim . . . [t]he term 'debtor' means person or municipality concerning which a case under this title has been commenced."[114] These definitions clearly encompass the pension fund as debtor and pension obligations as "debt" of the pension fund, in view of the fact that beneficiaries' claims are indeed liabilities on a fund of undifferentiated assets.[115] Although a pension fund has the legal authority to seek contributions from employers and employees to meet the demands on its assets to pay pension benefits, it remains independent from them and directly liable to pay those benefits to current beneficiaries out of the undifferentiated assets it holds, including investment income, regardless of whether contributions are made and regardless of the source of available assets. A claim for pension benefits is thus clearly a claim on the pension fund itself, which can be adjusted in bankruptcy like all other debts of a petitioner. Moreover, "a claimant to a commingled trust fund bears the burden of ascertaining and tracing the trust property. If the funds are dissipated and cannot be traced, then the claimant stands in the position of a general creditor with regard to those funds."[116]

A claim for pension benefits is thus clearly a claim on the pension fund itself, which can be adjusted in bankruptcy like all other debts of a petitioner.

In sum, there is little doubt that a pension fund structured like Arizona's major pension funds would meet all of the threshold requirements for filing a Chapter 9 bankruptcy and having pension benefit obligations adjusted by the bankruptcy court: 1) it is an instrumentality of the state in the sense relevant to Chapter 9, thus fulfilling the definition of "municipality;" 2) a pension fund qualifies as a "debtor" in relation to vested pension benefits; 3) the vested benefits of current and future retirees are "debts" of the pension fund; and 4) its pension fund assets and liabilities comprise the pension fund's "bankruptcy estate," which are subject to adjustment. This conclusion is further fortified by the rule of liberal construction long applied to the bankruptcy code, which recognizes that Congress generally intended for its remedial structure to be broadly available to debtors whenever its purposes would be served.[117]

Don't Forget Legal Authority to File Bankruptcy

Only one question remains: when can a pension fund file for bankruptcy protection? First of all, before any governmental body can file for Chapter 9 bankruptcy, it must have been specifically authorized by state law to do so.[118] This is a consequence of Supreme Court precedent that held an early version of Chapter 9 unconstitutional under the Tenth Amendment because it allowed for involuntary bankruptcy proceedings by municipalities or the filing of bankruptcy proceedings by municipalities without state law authority.[119] No state currently authorizes its public pension funds to file for Chapter 9 bankruptcy, so overcoming this hurdle requires legislative action. Assuming this hurdle can be surmounted politically, the law requires the would-be petitioner to make a good faith effort to meet with its creditors, propose a plan to preserve solvency, and to reach a work-out agreement if possible. This hurdle is easy enough to jump. But it is not the last hurdle.

From existing Chapter 9 precedent, it is clear that municipal insolvency is very narrowly construed when it comes to determining eligibility for bankruptcy protection. It is not enough for liabilities to swamp assets. In essence, a municipality will be deemed insolvent and eligible for bankruptcy protection only when it can reasonably project that it will be unable to meet cash-flow requirements to pay its obligations—in this case, pension benefits—within the coming year.[120]

Forecasters have predicted that the "solvency horizon" for public pension funds begins in the year 2020 for seven states and six big cities, with the next major horizon arising between 2020 and 2025 in another 20 states and 24 localities.[121] For this reason, showing a likely cash-flow shortfall within the coming year may be challenging even if pension fund managers were to adopt a discount rate for their investments that reflects the Treasury rate.[122] But that difficulty does not make Chapter 9 valueless.

Forecasters have predicted that the "solvency horizon" for public pension funds begins in the year 2020 for seven states and six big cities, with the next major horizon arising between 2020 and 2025 in another 20 states and 24 localities.

Legislate to Maximize Leverage for Voluntary Reform

The threat of filing for bankruptcy may be the only way to give a pension fund any leverage in negotiations with beneficiaries who claim vested pension fund rights in an otherwise hostile legal environment for pension reforms. Indeed, the negotiating context of the pre-filing stakeholders meeting that is a requisite for filing Chapter 9 bankruptcy may be the best possible forum for advancing legal theories that justify reducing pension benefits or increasing employee contributions. The real question is how can policymakers best create such leverage for pension fund managers to motivate all stakeholders to reach a sustainable solution to our pension system?

At a minimum, legislation should be enacted that specifically authorizes all independent public pension funds whose boards are appointed by elected state officials to file for Chapter 9 bankruptcy. So long as a pension fund is legally distinct from the state itself, serving a public function and yet under state control, it should qualify as an instrumentality of the state under the definition of "municipality" used in Chapter 9. The mere passage of such a law would send a shot across the bow to stakeholders that should soften their refusal to consider reform proposals. But if policymakers wish to deploy maximum leverage, they should consider taking it up a notch.

To maximize leverage to procure agreement to pension fund reforms from all stakeholders, policymakers should consider enacting legislation that would require pension funds to file for Chapter 9 bankruptcy if they project a cash-flow shortfall based on a Treasury discount rate for pension assets within one year and to start work-out discussions with stakeholders as soon as they project such a shortfall within five years. The legislation should ensure that work-out meetings are held periodically, involve the discussion of a specific work-out plan, and if unsuccessful, indisputably fulfill all prerequisites for filing for Chapter 9 bankruptcy. A period of five years is recommended for such negotiations because it should allow for enough time to exhaust efforts to reach agreement on a work-out plan that can "course correct" the pension fund and avoid the necessity of filing for bankruptcy. A Treasury discount rate should be used to determine the adequacy of future cash flows for purposes of filing for Chapter 9 bankruptcy based on the previous observation that it is commensurate with the near certainty of the obligation to pay vested pension benefits. Appendix A includes the language of corresponding "model legislation."

In this way, creating authority for pension funds to file bankruptcy may generate reform without a single petition being filed. And if bankruptcy truly becomes unavoidable, the broad remedial powers given to the bankruptcy court will likely allow for the modification of plans, as needed, to preserve their solvency notwithstanding the modern "vested rights" approach to benefits.

Recommendations

Creating authority for pension funds to file bankruptcy may generate reform without a single petition being filed.

- Place new public employees, including local government employees, on 401(k)-type (actually 403(b)) defined contribution plans to begin to staunch the financial bleeding into pension funds.
- Condition acceptance of promotions and other major changes in employee status on acceptance of moving to a defined contribution plan.
- Enact a maximum combined (employee and employer) contribution rate no greater than 16 percent.
- Constitutionally require a supermajority of the legislature to increase pension benefits through retirement formula elements controlled by the legislature. This includes anything that can reduce the full-benefit retirement age, retirement multipliers, and arbitrary benefit increases for those already receiving pensions.
- Enact legislation requiring pension fund trustees to recognize they have a fiduciary duty to adopt a more realistic rate of return (ranging from a 10- or 30-year Treasury rate to a 5 percent rate of return) or risk personal liability for gross negligence. This would reveal that pension benefits being paid to current retirees discriminate against future retirees by dissipating pension fund assets. The same legislation should

then reduce current retiree benefits to enforce the pension fund's equal duty to fund the benefits of future retirees.

- In states that have constitutional Gift Clauses, use legislation or litigation: (1) to bar public employers from paying any increase in their contribution rate that is attributable to the replenishment of pension funds due to investment losses, increases in benefits to current retirees, or financial mismanagement; and (2) to cap the present value of pension benefits for any employee at retirement at no more than 125 percent of the sum of contributions to the fund attributable to that employee after the sum is adjusted upward by a reasonable rate of return over the span of the employee's career (also requiring pension fund managers to adjust the stream of pension fund payouts accordingly).
- Finally, policymakers should enact legislation authorizing independent pension systems to file for Chapter 9 bankruptcy and imposing the obligation on pension fund trustees to commence workout negotiations well in advance of any insolvency horizon.

Public pension systems must be reformed to maintain their solvency and to preserve the fiscal health of state and local government.

Conclusion

Public pension systems must be reformed to maintain their solvency and to preserve the fiscal health of state and local government. Outrageously, the current law affords few options for reform. But there are options depending on the litigation risk tolerance and political will of policymakers. At the low end of the spectrum, defined contribution programs can be established for new hires, incentives can be created for voluntary abandonment of defined benefit programs by existing employees, and promotions can be offered in exchange for benefit reductions. At the high-risk end of the spectrum, legislatures should require pension funds to assume a Treasury-based discount rate and to adjust the benefits of current retirees and contributions of future retirees to preserve trust assets for future retirees. Alternatively, legislation and litigation under the Gift Clause may force pension reform as the only available remedy. But if all else fails, the option of bankruptcy is a real one—not just for municipal employers, but also for the funds themselves. At the very least, statutory authority should be given to independent public pension funds to sidestep the rigged legal landscape that faces any pension reform effort. Even without filing for Chapter 9 bankruptcy, such a law would send a strong message to interested parties and finally create the leverage needed to build a consensus around pension reform. Policymakers might even stop the pension fund train wreck before it happens.

Appendix A: Model Legislation

REFERENCE TITLE: ____________
State of ______
(Introducing ______)
H. B. ____

Introduced by ______________________

AN ACT

RELATING TO BANKRUPTCY OF POLITICAL SUBDIVISIONS AND INSTRUMENTALITIES OF THE STATE.

***

Be it enacted by the Legislature of the State of _______:

Section 1. Title ___, chapter __, article ___, _____ Revised Statutes, is amended by adding section _____, *et seq*., to read:

Section 2. § _____. Definitions

For the purposes of this article:

1. "Federal bankruptcy statute" means the act of Congress entitled, "An act to establish a uniform system of bankruptcy throughout the United States," including Chapter 9 thereof, which was originally approved July 1, 1898, as amended or supplemented.

2. "Eligible Debtor" means "municipality" as broadly defined in the federal bankruptcy statute, including any political subdivision, public agency or instrumentality of the State of Arizona, such as any local government, taxing district, or independent pension fund operating under A.R.S. §§ 38-712, et seq., 38-801, et seq., 38-841, et seq., 38-882, et seq., or local law.

Section 2. § 35-602. Exercise of powers

All powers granted by this article to Eligible Debtors may be exercised by such debtors, or, if such debtors have no officers of their own, may be exercised by the officers who have the authority to contract on behalf of such debtors, or to levy special assessments or special taxes within their jurisdiction.

Section 3. § 35-603. Filing petition; payment of expenses

Any Eligible Debtor in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as it may be modified from time to time.

Section 4. § 35-604. Resolution authorizing filing of petition and representation of Eligible Debtor by attorney

A. Before the filing of the petition referred to in section 35-603, the Eligible Debtor shall adopt a resolution authorizing the filing thereof and authorizing its duly and regularly elected or appointed attorney, or special counsel appointed for such purpose, to file the petition and to represent the Eligible Debtor in the proceedings with respect thereto in the United States district court having jurisdiction thereof.

B. In the case of pension funds that project the inability to pay pension obligations when due within five years based on a discount rate that is equal to the U.S. Treasury ___ Year Yield, the following actions shall be taken by its governing body immediately upon receipt of notice of such inability: (1) the governing body of the pension fund must draft an initial plan to adjust the debts and liabilities of the pension fund by increasing employee contribution requirements, decreasing employee benefits, or adopting a defined contribution pension plan for new or existing employees; and (2) the governing body of the pension fund must organize at least quarterly meetings with beneficiaries or their representatives, as well as all other creditors, at which to engage in good faith negotiations over whether to adopt the plan prior to filing the petition. Said meetings shall be scheduled until agreement is reached and shall be conducted in a timely fashion and in conformity with the federal bankruptcy statute, if applicable.

Section 5. § 35-605. Powers of Eligible Debtor

Any Eligible Debtor is authorized and empowered to take any and all action necessary to carry out any plan of readjustment contemplated in the petition, or as such petition is modified from time to time, subject only to the provisions of the constitution of this state, any other provision of law to the contrary notwithstanding; however, pension funds may not increase employer contribution requirements.

Section 6. § 35-606. Resolution of Eligible Debtor assenting to plan as prerequisite of final decree of court becoming effective

No final decree or order of the United States district court confirming a plan of readjustment shall be effective for the purpose of binding the Eligible Debtor unless and until the debtor files with the court a certified copy of a resolution of such debtor, adopted by it or by the officials referred to in section 35-602, consenting to the plan of readjustment set forth or referred to in such final decree or order.

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17. The author looked at assets at the end of 2000, added three percent of assets, subtracted 2001 benefits and added 2001 contributions to get an asset level for the end of 2001 and so on through 2011 for each of the Arizona pension systems to obtain this figure.

18. *See, e.g., Strunk v. Public Employees Retirement Bd.*, 108 P. 3d 1058 (Or. 2005); *Booth v. Sims*, 456 S.E.2d 167 (W. Va. 1995); *Norton v. Arizona Department of Public Safety Local Retirement Board*, 150 Ariz. 303 (1986); *Pasadena Police Officers Ass'n v. City of Pasadena*, 147 Cal. App. 3d 695, 702 (1983).

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24. Pennie, 132 U.S. at 471.

25. *See, e.g.*, A.R.S. § 38-791(E).

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27. A.R.S. § 38-794.

28. A.R.S. § 38-903.

29. *See, e.g.*, A.R.S. §§ 38-757 ("[e]xcept as provided in section 38-768, a member who *meets the requirements for retirement benefits at normal retirement* shall receive a monthly life annuity…"), 38-810.02 ("[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"), 38-844.01 ("A member of the system does not have vested rights to benefits under the system . . . until he files an application for benefits and is found eligible for those benefits"), 38-850(B), 38-884.

30. *Proksa*, 205 Ariz. at 629 (observing "[t]he general principle, however, is that statutes do not create contract rights") (citing *Nat'l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry.,* 470 U.S. 451, 465–66 (1985); *Dodge v. Bd. of Educ.*, 302 U.S. 74, 79 (1937)).

31. *Jackson Sawmill Co., Inc. v. United States*, 580 F.2d 302, 306–07 (8th Cir.1978).

32. *Minneapolis Taxi Owners Coalition, Inc. v. City of Minneapolis*, 572 F.3d 502 (2009); *Mitchell Arms, Inc. v. United States*, 7 F.3d 212, 216 (Fed.Cir.1993) (stating that an enforceable property interest "cannot arise in an area voluntarily entered into and one which, from the start, is subject to pervasive Government control," because the government's retention of discretion over that area means that the individual "cannot be said to possess the right to exclude" [internal quotations, citation, and emphasis omitted]); *Rogers Truck Line, Inc. v. United States*, 14 Cl.Ct. 108, 111 (1987) (holding that a commercial-carrier license "did not give plaintiffs a constitutionally protected freedom from competition").

33. *Proksa*, 205 Ariz. at 630.

34. *See, e.g.*, U.S. Const. Art. I, § 10; Ariz. Const. Art II, sec. 25.

35. *United States v. Winstar Corp.*, 518 U.S. 839, 872 (1996) (citing William Blackstone, Commentaries *90); John C. Roberts & Erwin Chemerinsky, *Entrenchment of Ordinary Legislation: A Reply to Professors Posner and Vermeule*, 91 Cal. L. Rev. 1773, 1775 (2003) (discussing legislative entrenchment and its constitutionality).

36. Roberts, *Supra* note 1, at 1775.

37. Winstar Corp., 518 U.S. at 874.

38. Id. at 874-879.

39. *Ohio Life Ins. & Trust Co. v. Debolt*, 57 U.S. 416, 431 (1853). (This case dealt with a contract in which a previous legislature capped the tax of bank dividends and capital stock at 5 percent. When a subsequent legislature passed a new act increasing taxes the bank refused to pay. The court noted that the "powers of sovereignty confided to the legislative body of a State are undoubtedly a trust committed to them, to be executed to the best of their judgment for the public good; and no one Legislature can, by its own act, disarm their successors of any of the powers or rights of sovereignty confided by the people to the legislative body.")

40. *See, e.g., Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 413 n.14 (1983).

41. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 23 (1977).

42. 839 So. 2d 809, 850 (La. 2005).

43. Arizona's ASRS fund specifically defines employee contributions as "equal" to employer contributions. A.R.S. § 38-736(A).

44. *Kern v. City of Long Beach*, 29 Cal. 2d 848, 853 (1947).

45. *See, e.g., United Firefighters of Los Angeles City v. Los Angeles*, 210 Cal. App. 3d 1095, 1107-8 (Ct. App. 1989); *State v. Slinger*, 73 N.E.2d 385 (Ohio Ct. App. 1946); *Brophy v. Employees Retirement System*, 71 Cal. App. 2d 455 (1945); *State v. Gantter*, 4 N.W.2d 153 (Wis. 1942).

46. 290 U.S. 398 (1934).

47. *Brazelton v. Kansas Public Employees Retirement System*, 227 Kan. 443, 453 (1980) (citing "California Rule" that "alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation").

48. *Cranford v. Wayne County*, 402 N.W.2d 64 (Mich. Ct. App. 1986).

49. *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882, 884 (Alaska 2003).

50. *McClead*, 174 Ariz. at 357.

51. Frances Denmark, Debate Heats Up Over Public Pension Fund Discount Rates, http://www.institutionalinvestor.com/Article/3150302/Investors/Debate-Heats-Up-over-Public-Pension-Fund-Discount-Rates.html (February 13, 2013) (last visited May 9, 2013).

52. *Ariz. Center for Law in the Public Interest v. Hassell*, 172 Ariz. 356, 366-67 (Ct. App. 1991); *Walker v. Bd. of Trustees*, 69 Fed. Appx. 953 (10th Cir. 2003); *Dardaganis v. Grace Capital, Inc.*, 889 F.2d 1237 (2nd Cir. 1989); *Citro v. TRW, Inc.*, 1984 U.S. Dist. LEXIS 22811, 9-11 (N.D. Ohio 1984) ("fiduciaries may not arbitrarily and capriciously discriminate among plan participants"); *Winpsinger v. Aurora Corp. of Illinois*, 456 F. Supp. 559 (N.D. Ohio 1978); *Goodridge v. Nat'l Bank of Commerce of Norfolk*, 106 S.E.2d 598 (Va. 1959); *Atty. Gen. v. Soc'y for Relief of Elderly & Disabled Ministers*, 29 S.C. Eq. 190 (S.C. App. Eq. 1856).

53. *See, e.g., Brown v. Brewer*, 2010 U.S. Dist. LEXIS 60863 (C.D. Cal. 2010) (intentional dereliction of duty or conscious disregard for one's responsibilities is a "non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith"); *Meyers v. Moody*, 693 F.2d 1196, 1210 (5th Cir. 1982) (jury could find gross negligence from embarking on massive acquisition program in disregard of extreme volatility that could "instantly" result in insolvency).

54. *See, e.g.*, Ariz. Const. art. 29, sec. 1(B); A.R.S. § 38-843.02.

55. *See, e.g.*, A.R.S. § 38-717.

56. *See, e.g.*, MI Const., art. 9, sec. 9, 24; MI Atty Gen. Op. No. 7195 (2006); NM Const. art. 20, sec. 22(B); *Cella v. Sanitary Dist. Employees' & Trustees' Annuity & Benefit Fund*, 266 Ill. App. 3d 558, 563 (Ct. App. 1994).

57. Ellman & Merrett, *supra*, at 374-75.

58. Att. Gen. Op. No. I09-009 (R08-059) (Nov. 24, 2009).

59. http://chicagoist.com/2012/05/08/emanuels_pension_reform_raise_retir.php

60. http://www.senatedem.ilga.gov/images/pensions/A/Sidley%20Guarantor%20Memo.pdf

61. 523 F. Supp. 2d 731, 749 (N.D. Ill. 2007).

62. Ariz. Const., art. 29, sec. 1(B).

63. A.R.S. § 38-850(B).

64. *McClead*, 174 Ariz. at 357 (dealing with Ariz. Const. art. IV, pt. 2, § 17).

65. Ill. Const. art. IV, § 19, Mo. Const. art. III, § 39(3); Neb. Const. art. III, § 19; Pa. Const. art. III, § 11; Wa. Const. art. II, § 25; Wis. Const. art. IV, § 26.

66. A.R.S. § 38-729.

67. A.R.S. § 38-791(E).

68. *See, e.g.*, A.R.S. §§ 38-723, 724.

69. A.R.S. §§ 38-737, 38-738.

70. It is unclear whether the same analysis would apply to employer contribution obligations in the PSPRS and CORP systems because A.R.S. §§ 38-843, 843.01, 891, and 892 could be construed as requiring employers to fund shortfalls when they "pick up" the cost of benefits paid thereafter.

71. *Turken v. Gordon*, 223 Ariz. 342, 348 (2010).

72. *See, e.g., United States v. County of Macon*, 99 U.S. 582 (1879); *Miners & Merchants Bank v. Herron*, 46 Ariz. 71, 76-77 (1935) ("[t]here is no connection between the power to contract debts and the power to levy taxes"); *Tucker v. Raleigh*, 75 N.C. 267 (1876) ("every creditor is presumed to know the extent of the power to tax and the means to pay").

73. *Missouri v. Jenkins*, 495 U.S. 33, 58 (1990) (distinguishing County of Macon from situation in which court order compelling local governments to raise taxes and appropriate funds was intended to effectuate a decreed remedy for Equal Protection violations); *United States Trust Co. v. New Jersey*, 431 U.S. 1, 24 (1977) ("[t]he taxing power may have to be exercised if debts are to be repaid"); *Louisiana v. New Orleans*, 215 U.S. 170, 181 (1909) (ruling court had power to compel city to levy tax for debt secured by court judgment).

74. Author's calculation based on table in Matthew D. Cavenaugh, *A Pathway to State Bankruptcy*, 30-OCT Am. Bankr. Inst. J. 12, *12 (Oct. 2011) (citing Joshua Rauh, "The Pension Bomb," *The Milken Institute Review*, First Quarter 2011, 29).

75. Jagadeesh Gokhale, *State and Local Pension Plans Funding Status, Asset Management, and a Look Ahead*, 4 (2012).

76. Nicholas J. Houpt, Note, *Shopping for State Constitutions: Gift Clauses As Obstacles to State Encouragement of Carbon Sequestration*, 36 Colum. J. Envtl. L. 359, 363-64, 381-83 (2011), http://web.law.columbia.edu/sites/default/files/microsites/climate-change/files/Publications/Students/Houpt_ShoppingforStateConstitutions.pdf (last visited May 9, 2013).

77. *See, e.g., McClead v. Pima County*, 174 Ariz. 348, 357 (Ct. App. 1992).

78. 223 Ariz. at 348.

79. The rate of return on the lowest-risk investment vehicle is appropriate to approximate the market value of a near-certain retirement benefit.

80. This insight is attributable to Goldwater Institute attorney Jonathan Riches.

81. This would create quite a conundrum for pension board members—but they might still have non-bankruptcy options created by the obligations imposed by their fiduciary role. Specifically, pension fund board members would still have an obligation to minimize the risk of insolvency in the pension fund for future retirees. The problem is that there are typically very few options available to the pension fund managers relative to adjusting the contribution and benefit scheme to resolve the intergenerational conflict. But to the extent that the statutory framework allows for pension managers to make equitable adjustments to contributions and benefits to ensure the viability of the pension fund for both future and current retirees, a strong legal argument can be made that, as fiduciaries, they must. The question is how? Answering this question will depend heavily on the statutory authority granted to

pension fund managers. In Arizona, for example, the pension board of the ASRS pension fund has the statutory power to increase contribution levels from employees and employers. Ordinarily, modern vested pension benefits doctrine would require pension managers to increase contributions either equally from employer and employee or solely from the employer. But as discussed above, there are legitimate questions surrounding the existence of taxpayer backing for employer contributions, as well as whether employers have any implied contractual liability to replace past contributions lost through investment mismanagement. As fiduciaries, pension fund managers cannot ignore these realities when determining contribution rates. They must take into consideration the possibility, and perhaps likelihood during times of economic distress, that neither taxpayer nor government employer resources will be available to rebalance assets and liabilities in light of a realistic discount rate. In planning for a shift to a realistic discount rate and corresponding investment strategy, pension fund managers would then have a fiduciary obligation to consider decoupling employee contributions from the level of employer contributions and increasing them asymmetrically. So long as doing so was necessary to ensure pension fund solvency, such that refraining from doing so would be regarded as favoring current over future retirees, an argument could be made that the fund managers' power and duty to take such action would be implicit in their fiduciary role as trustee of a public trust even without legislative reform.

82. *See, e.g.*, 11 U.S.C.S §§ 109, *et seq*.

83. In Arizona, this remedy is made all the more important by A.R.S. § 38-751(2), which immediately allocates to a municipal employer its entire ASRS contribution allocation upon filing Chapter 9 bankruptcy. Although this law could have been intended to give the bankruptcy court full jurisdiction to adjust all pension liabilities, it is more likely intended to prevent municipal employers from using Chapter 9 to minimize their pension liabilities. This interpretation is supported by the fact that the same law is also triggered by municipal dissolution and privatization of municipal services, which in no way enhances the scope of a bankruptcy trustee's jurisdiction but most certainly protects the ASRS contribution claims.

84. Hannah Heck, *Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option*, 28 Emory Bankr. Dev. J. 89, 98 (2011) (citing 11 U.S.C.S. §§ 109).

85. Current employees' pension "contracts" could be deemed executory and rejected, rendering their claims (if timely filed before the "bar date") prepetition, unsecured nonpriority claims. Ellman & Merrett, *supra*, at 400, 405. Although beneficiaries might attempt to assert a "wage" claim against a bankrupt pension fund for the value of contributions owed by employers or current employees to a pension fund, which would have a higher priority than general unsecured debt (or excluded from the bankruptcy estate—*see In re Prigge*, 441 B.R. 667, 677 [Bankr. D. Mont. 2010]), it is already well-established that the statutory obligation to make pension contributions is not an element of "wages" owed to beneficiaries, it is an unsecured debt owed to the pension fund. *Joint Industry Bd. of the Electrical Industry v. United States*, 391 U.S. 224 (1968); *United States v. Embassy Restaurant, Inc.*, 359 U.S. 29, 33 (1959); *Standard Cellulose & Novelty Co., Inc.*, 3 Bank. Ct. Dec. 695 (S.D. NY 1977).

86. Matthew D. Cavenaugh, *A Pathway to State Bankruptcy*, 30-8 ABIJ 12, 78 (Oct. 2011) ("the chapter 9 debtor is the only party able to propose a plan, and has an unlimited period within which to do so").

87. Ellman & Merrett, *supra*, at 386 n.87, 397-99.

88. *Assoc. of Retired Emp. v. City of Stockton*, 2012 Bankr. LEXIS 3660 (Bankr. E.D. Cal. Aug. 6, 2012).

89. Heck, *supra*, at 107-08, 117 ("Therefore, claims for pension contributions either (a) owed prior to the filing of the bankruptcy petition or (b) owed after the filing for work performed prior to the filing are typically treated as general unsecured claims. . . . The Code defines the term 'claim' as a 'right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.' This broad definition would likely encompass pension obligations owed to pensioners and would give the pensioners standing like any creditor"); Ellman & Merrett, *supra*, at 399-400, 409-10 ("the chapter 9 cram down rules permit a debt to overcome a dissenting class of creditors (such as a class including pension holders) if the debtor can demonstrate that the plan does not 'discriminate unfairly' against such dissenting class"). Although it is possible that a bankruptcy court might insist on the pension fund exercising its power to increase employer and employee contributions as part of the plan, there would be a defense to this effort, which should moderate it. This is because the power to determine contribution rates or execute on increased contributions are held by the pension fund for the benefit of current and future retirees. The code, however, specifically excludes from the bankruptcy estate powers that can be exercised only for the benefit of third parties. 11 U.S.C.S. § 541(b)(1). Consequently, an argument can be made that the bankruptcy court has no jurisdiction over such power and cannot compel increased contributions. But even if the power to compel increased contributions were technically within the bankruptcy estate, and subject to being exercised by the bankruptcy court, municipal government employers could themselves simply file for Chapter 9 bankruptcy if the demanded additional contributions threatened their ability to provide essential services with a cash-flow shortfall.

90. Ellman & Merrett, *supra*, at 386-87; *Corporacion de Servicios Medicos Hospitalarios de Fajardo v. Mora*, 805 F.2d 440, 446-47 (1st Cir. 1986); *In re Midway Airlines Corp.*, 283 B.R. 846, 851 (E.D.N.C. 2002).

91. Case No. 99-13465, Document Number 123, at 6-7 (Bankr. S.D. Ala. Oct. 6, 2000).

92. Pub. L. 94-260, 90 Stat. 315, § 84, 94th Congress, 2nd Sess., H.R. 10624 (1975).

93. Pub. L. 95-598, 92 Stat. 2549, 95th Congress, 2nd Sess., H.R. 8200 (1978).

94. H. Rep. No. 94-686, 94th Congress, 2nd Sess., 1975 WL 12383 at *20 (December 1, 1975).

95. Merriam-Webster's Collegiate Dictionary 605 (10th ed. 2001); Black's Law Dictionary 720 (5th ed. 1979) (defining "instrumental" as "serviceable, helpful; serving as a means or agent; something by which an end is achieved").

96. *See, e.g., In re Divco Philadelphia Sales Corp.*, 60 B.R. 323, 324 (Bankr. E.D. Pa. 1986) ("the Pension Fund is a United States instrumentality").

97. *In re Am. Int'l Group, Inc. Sec. Litig.*, 265 F.R.D. 157, 161 (S.D.N.Y. 2010) ("Lead Plaintiffs are three public pension funds that are instrumentalities of the State of Ohio"); *City & County of Denver v. Bd. of Assessment Appeals*, 30 P.3d 177, 179 (Colo. 2001) ("Under section 31-31-201(1), FPPA [Fire and Police Pension Association] is 'an independent public body corporate and politic,' a 'public instrumentality' exercising 'an essential public function,' and a 'political subdivision of the state,' but not 'an agency of state government'").

98. *White v. Cotzhausen*, 129 U.S. 329, 341 (1889) ("The rule in construing remedial statutes, though it may be in derogation of the common law is, that everything is to be done in advancement of the remedy that can be done consistently with any fair construction that can be put upon it."); see also *Wright v. Logan*, 315 U.S. 139, 141 (1942) ("the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress . . . lest

its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act"); *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 279 (1940) ("the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress, lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act"); *In re Peer Manor Bldg. Corp.*, 143 F.2d 769, 771 (7th Cir. Ill. 1944) (liberal construction applies to definitions); *In re Nautilus Virgin Charters, Inc.*, 22 B.R. 468, 472 (Bankr. D.V.I. 1982).

99. *In re County of Orange*, 183 B.R. 594, 605-07 (Bankr. C.D. Cal. 1995).

100. *Ex parte York Co. Natural Gas Auth.*, 238 F. Supp. 964, 976 (DC.S.C. 1965).

101. *In re Las Vegas Monorail Co.*, 429 B.R. 770, 788-89 (Bankr. D. Nev. 2010).

102. *Id.*

103. *Id.*

104. Notably, the retirement systems of Michigan, New York, Connecticut, Pennsylvania, Virginia, Tennessee, Nevada, Kansas, California, and South Carolina have been deemed "arms of the state" for Eleventh Amendment purposes. *See, e.g. Enrst v. Rising*, 427 F.3d 351 (6th Cir. 2005); *McGinty v. New York*, 251 F.3d 4, 100 (2nd Cir. 2001); *JMB Group Trust IV v. Penn. Mun. Ret. Sys.*, 986 F. Supp. 534, 538 (N.D. Ill. 1997); *Sculthorpe v. Va. Ret. Sys.*, 952 F. Supp. 307, 309-10 (E.D. Va. 1997); *Hair v. Tenn. Consol. Ret. Sys.*, 790 F. Supp. 1358, 1364 (M.D. Tenn. 1992); *Mello v. Woodhouse*, 744 F. Supp. 923, 930 (D. Nev. 1991); *Reiger v. Kan. Pub. Employees Ret. Sys.*, 755 F. Supp. 360, 361 (D. Kan. 1990); *Retired Pub. Employees' Ass'n of Cal., Chapter 22 v. California*, 614 F. Supp. 571, 573, 581 (N.D. Cal. 1984); *United States v. South Carolina*, 445 F. Supp. 1094, 1099-1100 (D.S.C. 1977). It is possible, although uncertain, that such a characterization would render them ineligible to qualify as a Chapter 9 municipality because municipalities have long been excluded from Eleventh Amendment protection and presumably an "arm of the State" is not equivalent to a "municipality." However, the distinction between an "arm of the state" and a "municipality" in the Eleventh Amendment context may not be relevant to a bankruptcy proceeding that is initiated with the consent of the state and the governmental petitioner. At least one case has deemed a municipality that was indisputably eligible to file under Chapter 9 an "arm of the state." *See Assoc. of Retired Emples. v. City of Stockton*, 2012 Bankr. LEXIS 3660 (Bankr. E.D. Cal. Aug. 6, 2012). Moreover, it appears that the laws establishing Michigan's pension fund, for example, do not establish it as an independent jural body; and the assumption of each of the foregoing cases was that a claim against the fund was ultimately a claim against the state, which is not necessarily the case for independent pension funds as discussed above.

105. Ariz. Const., art. 29, sec. 1(B); *see, e.g.*, A.R.S. §§38-714(A), 38-802(D), 38-841(E), 38-882(D), 38-893(A).

106. A.R.S. § 38-720(A).

107. A.R.S. § 38-848.

108. A.R.S. §§ 38-712, 38-848. It should be noted, however, that PSRS is administered by local boards. A.R.S. § 38-847.

109. A.R.S. § 38-721(C).

110. *Cf. In re Westchester County Civil Services Employees Association, Inc., Benefit Fund*, 111 Bankr. 451, 455-56 (Bkrtcy S.D.N.Y. 1900).

111. *In re Affiliated Food Stores, Inc., Group Benefit Trust*, 134 Bankr. 215 (Bankr. N.D. Tex. 1991).

112. 831 F. Supp. 1008, 1016-17 (E.D. NY 1993).

113. *Cf. In re Medallion Realty Trust*, 103 B.R. 8, 11-12 (Bankr. D. Mass. 1989) ("I conclude, therefore, that Congress intended to permit bankruptcy relief for all trusts which are created for the purpose of transacting business and whose beneficiaries make a contribution in money or money's worth to the enterprise, without regard to whether the trust has characteristics of a corporation such as separate certificates of ownership. The Debtor certainly meets this standard. But its trustee acts under the direction of the holders of a majority of its beneficial interests. This is the prime indicia of an agent, not a trustee, as explained in the leading treatise"); *see generally In re Maidman*, 668 F.2d 682, 685-686 (2nd Cir. 1982); *In re Secured Equipment Trust of Eastern Air Lines, Inc.*, 153 Bankr. 409, 1993 Bankr. LEXIS 594 at *11 (Bankr. S.D.N.Y. 1993); *In re Michigan Real Estate Ins. Trust*, 87 Bankr. 447, 449 (Bankr. E.D. Mich. 1988) (real estate trust funded for the purpose of reducing health care costs for members qualifies as business trust); *In re Tru Block Concrete Products, Inc.*, 27 Bankr. 486, 491 (Bankr. S.D. Cal. 1983).

114. 11 U.S.C.S. § 101(12), (13).

115. *In re County of Orange*, 183 B.R. at 605-07 ("Movants argue that the OCIP [pension fund] is not insolvent because the OCIP has no 'debts' and the OCIP participants are not 'creditors.' Instead, according to Cal Gov't Code § 27100.1 the OCIP is a trust. 28 Therefore, the OCIP assets belong to its participants, and no debtor-creditor relationship exists between the OCIP and its participants. Movants' argument, however, ignores the Code's broad definition of claim and creditor.") (citing *Danning v. Bozek*, 836 F.2d 1214 [9th Cir. 1988]).

116. *Id*. at 606 (citing *Kupetz v. United States*, 923 F.2d 641, 648 [9th Cir. 1991]).

117. *White*, 129 U.S. at 341; *Wright*, 315 U.S. at 141; *Wright*, 311 U.S. at 279; *In re Peer Manor Bldg. Corp.*, 143 F.2d at 771; *In re Nautilus Virgin Charters, Inc.*, 22 B.R. at 472.

118. Cavenaugh, *supra*, at 77-78.

119. *Ashton v. Cameron County Water Improvement District No. 1*, 298 U.S. 513, 530 (1936).

120. Heck, *supra*, at 119.

121. Cavenaugh, *supra*, at 12 (citing Joshua Rauh, "The Pension Bomb," *The Milken Institute Review*, (2011 Q1).

122. *See, e.g, Hamilton Creek Metro. Dist. v. Bondholders Colo. Bondshares*, 143 F.3d 1381, 1386 (10th Cir. Colo. 1998); *In re Bridgeport*, 129 B.R. 332, 338 (Bankr. D. Conn. 1991).

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