IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

ARIZONA STATE UNIVERSITY ex rel. ARIZONA BOARD OF REGENTS, a body corporate, Plaintiff/Appellant, v. ARIZONA STATE RETIREMENT SYSTEM, a body corporate, Defendant/Appellee.	Court of Appeals Division One No. 1 CA-CV 14-0083 Maricopa County Superior Court No. LC2012-000689-001

PLAINTIFF/APPELLANT'S OPENING BRIEF

Thomas L. Hudson (014485)
Eric M. Fraser (027241)
OSBORN MALEDON, P.A., No. 00196000
2929 North Central Avenue, 21st Floor
Phoenix, Arizona 85012-2793
(602) 640-9000
thudson@omlaw.com
efraser@omlaw.com

Lisa K. Hudson (012597)
Associate General Counsel
ARIZONA BOARD OF REGENTS,
for and on behalf of
ARIZONA STATE UNIVERSITY
P.O. Box 877405
Tempe, Arizona 85287-7405
(480) 965-8611
lisa.k.hudson@asu.edu

Attorneys for Plaintiff/Appellant

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INTRODUCTION[*]

In 2011, the Arizona State Retirement System Board charged Arizona State University over $1 million under A.R.S. § 38-749 because 17 ASU employees—all eligible for normal retirement—participated in a modest termination incentive program. Although that statute permits ASRS to charge employers for "an actuarial unfunded liability" that "results" from a "termination incentive program," the Board's decision to impose this charge on ASU is contrary to law for two reasons.

First, ASRS is subject to the rulemaking requirements of the Administrative Procedure Act, and § 38-749 is not self-executing; ASRS had to implement it pursuant to the rulemaking requirements of the Administrative Procedure Act. In fact, ASRS's "rule writer" requested that the Legislature ***temporarily*** exempt § 38-749 from the APA's rulemaking requirement, but the Legislature rejected that request. (*See* APP441:20–442:3; Hearing Audio Clip 1; *see also* APP435:13-16.)[1]

[*] Most record items cited are included in the Plaintiff/Appellant's Separate Appendix to Opening Brief, which is cited by page number (e.g., APP001), which also matches the electronic PDF page numbers. Case citations include hyperlinks to Westlaw. The brief also includes an embedded audio clip in .mp3 format from the March 8, 2004 hearing on HB2052 before the Senate Finance Committee.

[1] The embedded audio clip, which is in .mp3 format, is attached to the PDF and can be accessed in Adobe Reader showing attachments. To show attachments click "View" "Show/Hide" "Navigation Panes" "Attachments" or by holding down Alt and typing the following four letters: v s n m. Because technical limitations may prevent the Court from accessing this file, ASU filed an unopposed motion on

ASRS then proceeded to develop and adopt "an agency statement of general applicability" that both (1) "implements" and "interprets" § 38-749 and (2) "describes" ASRS's "procedure or practice requirements" concerning § 38-749—the statutory definition of a "rule" under the APA. A.R.S. § 41-1001(18). In adopting this rule, however, ASRS failed to comply with the APA rulemaking requirements, which renders the rule and ASRS's action thereunder void. Therefore, ASRS must refund the $1,149,103 it charged ASU for the incentive program. *See*, *e.g.*, *Carondelet Health Servs., Inc. v. Ariz. Health Care Cost Containment Sys. Admin.*, 182 Ariz. 221, 230, 895 P.2d 133, 142 (App. 1994) (holding that AHCCCS had to "compensate" all hospitals for all reductions in reimbursement based on a methodology that should have gone through the rulemaking process).

Second, although the Legislature gave ASRS some flexibility in connection with § 38-749's implementation, the rule ASRS adopted and applied to ASU runs afoul of one of the things § 38-749 forbids: charging employers for liabilities that do not "result[]" from "a termination incentive program." A.R.S. § 38-749(A). In fact, although ASRS assumes that a certain number of ASRS members will retire each year—and plans accordingly for each age and service decrement—ASRS fails

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April 17, 2014 for leave to provide the Court with the recording in several different formats. As of the date of filing this brief, the Court has not ruled on the motion.

to account for whether an incentive program results in additional retirements that would not have otherwise occurred without the program. Consequently, ASRS charged ASU for everyone who participated in the incentive program—as if no one who participated would have retired otherwise—rather than the additional "cost of the unfunded liability" that "result[ed]" from the incentive program, as required by § 38-749.

In sum, ASRS misconstrued both A.R.S. § 41-1001(18) and A.R.S. § 38-749, and as a result charged ASU without the proper authority to do so, and overcharged ASU at that. The Court should accordingly declare the assessed charge void and order ASRS to refund it.

STATEMENT OF THE FACTS AND CASE

I. The ASRS Pension Plan and the General Concept of Unfunded Actuarial Accrued Liability

The Arizona State Retirement System provides pension benefits to eligible employees, including ASU employees who participate in ASRS (rather than in ASU's optional retirement plan). A.R.S. §§ 38-711(13) & 38-729. When an ASRS member retires, ASRS pays monthly retirement benefits based upon the retiree's age, years of service, and average compensation over a period of months. *See generally* A.R.S. § 38-757; (APP105:21–APP107:20). In addition, ASRS members may receive a health insurance premium subsidy funded by employer contributions. A.R.S. § 38-783; (APP111:9–APP112:13; APP182:7–21).

Employers and employees make contributions that, together with interest and investment returns, fund those retirement benefits. Ariz. Const. art. XXIX, § 1.

To ensure ASRS remains financially healthy, ASRS regularly compares its assets to its expected liabilities. Using a method specified by statute, A.R.S. § 38-737(A), ASRS divides its liabilities "between the future service liability" (the expected future liability for active ASRS members who make ongoing contributions) "and the past service liability" (the expected liability for members' past service, which will be paid as a pension). (APP141:18–21.) ASRS compares the past service liability to the assets, and "[t]he shortfall is the deficit or unfunded actuarial accrued liability . . . ." (APP141:22–24.) In simple terms, the actuarial accrued unfunded liability is the difference between what the plan expects to pay members for service earned to date, less the value of assets that have been accumulated for the purpose of paying benefits.

II. ASRS's Calculation of Contribution Rates

ASRS calculates contribution rates to take into account both the future and past service liability. (APP142:2–7.) The "normal cost" is the cost associated with one year of future service—the annual contribution rate necessary in the absence of any actuarial accrued unfunded liability. (APP142:2–3.) ASRS then calculates the cost associated with the actuarial accrued unfunded liability, if any, using a "rolling 30-year period" amortization period. (APP141:22–APP142:20;

APP142:2–20.) ASRS determines the contribution rate by combining the normal cost with the "30-year amortization payment on the unfunded" liability. (APP142:4–7.)

Making these calculations necessarily requires making a large number of assumptions, including the rate of return for the investments, the percentage of members the plan expects to retire at each age, how long retirees will live, etc. (APP066:23–APP067:19.) The ASRS Board accordingly adopts assumptions for these calculations in consultation with its actuary, and revises them every five years after conducting an experience study. (APP326; APP014–015 ¶ 16; APP143:13–APP144:1; APP147:5–15.) For example, ASRS's actuaries assume that an individual age 65 with 40 years of service has a 30% chance of retiring in that year, meaning that if ASRS has 100 active members in this category in a particular year, it expects 30 will retire. (APP326; APP223:14–18.)

III. The Unfunded Liability Caused by Some Termination Incentive Plans

Normally, when a particular employee retires, there should be no additional charge to the employer because the employer and employee have already made the contributions necessary to fund the pension and other benefits. (*See* APP142:8–APP143:12.) For example, if an employer has 100 employees age 65 with 40 years of service (each with an assumed 30% chance of retiring), ASRS assumes that 30 of these individuals will retire in a given year, and accordingly will have

built into the contribution rate the amounts necessary to fund these expected retirements. In other words, the 30 retirees in this example would be an expected cost for which ASRS planned. Such retirements do not result in any additional unfunded liability. (*Cf.* APP220:5–10 (ASRS actuary explaining that when employees retire without participating in an incentive program, there is no additional charge to the employer).)

If, however, an employer takes steps to incentivize employees to retire sooner than ASRS expects, that can adversely impact ASRS. For example, for ASRS members whose membership began between 1984 and 2011, ASRS calculates the member's "[a]verage monthly compensation" for purposes of determining the pension benefit by averaging the employee's "highest" "thirty-six consecutive months" of compensation received during the past ten years. A.R.S. § 38-711(5)(ii)(b); (APP108:4–6). Accordingly, if an employer offers to double an employee's salary for one year if the employee then retires (say from $50,000 to $100,000), the employee's "average monthly compensation" under A.R.S. § 38-711 (5)(ii)(b) climbs from $50,000 to $66,666—a nearly $17,000 or 34% increase. However, because the employee works at that higher level of salary for only one year (and the increase far exceeds ASRS's assumptions), ASRS will not collect sufficient contributions to fund the lifetime benefit based on that 34% greater salary. Consequently, this "salary spiking" creates an unfunded liability for ASRS,

which may then affect other employer/member contribution rates. (*See* APP437:2–11; APP439:15–APP440:11; APP154:8–12; APP205:4–9 (noting that ASRS makes assumptions about the rates at which salaries increase).) And, if the incentive in fact caused the retirement—that is, the employee would not have retired without the incentive—then ASRS loses the contributions for this member sooner than expected, and must pay benefits longer than expected.

IV. The Legislature's Response to Termination Incentive Programs and the Decision to Leave the Applicable APA Rulemaking Requirements Intact

In 2004, in the face of perceived abuses by some employers of such incentive programs, (APP435:23–APP436:6), HB 2052 was introduced to establish "guidelines for retirement incentive programs" that "result[] in an unfunded liability to the ASRS."[2] (APP428; *accord* APP431; *see also* APP112:23–APP114:8.) As ASRS Deputy Director of External Affairs Richard Stevenson testified during a hearing before the Senate Finance Committee, the "bill would set forth that any employer that offers a retirement incentive program which ***causes*** an unfunded liability on the system, that the employer would have to pay the difference and pay for the unfunded liability." (APP436:7–11 (emphasis added).)

[2] The Court may take judicial notice of these legislative materials. *Hayes v. Cont'l Ins. Co.*, 178 Ariz. 264, 269 n.5, 872 P.2d 668, 673 n.5 (1994) ("Such records are an appropriate subject for judicial notice.").

To put the bill in context, Stevenson used the above example of an employer offering to double an employee's salary from $50,000 to $100,000 if the employee retires. (APP439:15–APP440:1.) He explained that such a salary spike would then "increase[] the annual average [salary] by $17,000 or so," which then results in a higher annual pension." (APP439:25–440:1.) In that circumstance, he explained, ASRS would calculate the "present cash value" of the increased benefit, and bill that difference to the employer so that "contribution rates would not have to be increased for all the other members and employers." (APP440:6–11.)

The bill passed, and A.R.S. § 38-749 now provides that "[i]f a termination incentive program that is offered by an employer results in an actuarial unfunded liability to ASRS, the employer shall pay to ASRS the amount of the unfunded liability." A.R.S. § 38-749 (A).[3] The statute defines "termination incentive program" to include salary spiking (defined as a 30% or more salary increase that affects the benefit calculation). A.R.S. § 38-749 (D). It then also sweeps in "***anything*** of value"—from movie tickets to large lump sum payments—"that the employer provides to or on behalf of a member that is conditioned on the member's termination . . . ." *Id.* (emphasis added). But § 38-749 does not prohibit

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[3] The Legislature made minor amendments to A.R.S. § 38-749 in 2006 and 2009, but none of these changes are relevant to this appeal. *See* 2006 Ariz. Sess. Laws 2d Reg. Sess., Ch. 106, § 1; 2009 Ariz. Sess. Laws 1st Reg. Sess., Ch. 36, § 10.

termination incentive programs, and as Stevenson explained at the hearing, it "was not intended to stop the retirement incentive programs." (APP438:14–15.)

During the hearing, Stevenson also addressed a proposed amendment concerning rulemaking. Because ASRS is subject to the APS's rulemaking requirements (*see* Argument § I.C), HB 2052 initially included a temporary exemption to the required APA rulemaking: "For the purposes of this act, the Arizona state retirement system [*sic*] is exempt from the rule making requirements of" the APA "for eighteen months after the effective date of this act." (APP315–16.) An amendment to the bill struck that exemption, thereby re-subjecting § 38-749 to the rulemaking requirements of the APA. (APP319.) During the hearing before the Senate Finance Committee, Senator Burns asked Stevenson whether the amendment gave ASRS "any heartburn," i.e., could ASRS live with the rulemaking requirement. Stevenson candidly explained that "the [temporary] exemption from rulemaking was a suggestion from our rule writer," i.e., someone at ASRS wanted to do less work (which prompted laughter from the audience). (APP441:23–APP442:3.) HB 2052 passed with the amendment striking the rulemaking exemption.

V. ASRS's Implementation of A.R.S. § 38-749 Outside of the APA, and the Assumption That Everyone Who Participates in an Incentive Program Retired Because of the Program

Although § 38-749(A) requires ASRS to "determine the amount of the unfunded liability in consultation with its actuary," ASRS's actuary admitted that (1) the statute "doesn't say how to calculate" the unfunded liability, (APP212:25–APP213:4), and (2) "[t]he actuarial standards don't address how to calculate this unfunded liability. They're much more general." (APP213:20–APP214:4.) Accordingly, the statute left § 38-749 to the rulemaking process for implementation "in consultation with" the actuary, but placed limits on what ASRS could do (such as limiting any charge to the unfunded liability resulting from an incentive program).

Accordingly, ASRS's executive staff met with ASRS's actuary Charles Chittendon "to discuss how we were going to do [ASRS's] calculations" under A.R.S. § 38-749. (APP191:13-19.) Because "there are different ways to calculate this" unfunded liability, (APP263:18–23), the ASRS "executive staff asked [Mr. Chittendon] to draft a document that would pin . . . down in writing, reduce . . . to writing," the methodology ASRS would adopt to implement § 38-749. (APP191:13-19.) As part of this process, ASRS considered at least two different methodologies which were "discussed at length" by "ASRS executive staff." (APP189:9–APP190:4; *see also* APP191:20–25 (discussing the "two methods of

calculating the unfunded liability.”).) This behind-the-scenes process resulted in the “ASRS Policy on Employer Early Termination Incentive Programs.” (APP311–12 (“**ASRS Policy**”)).

Under that Policy, ASRS calculates two components—the “401(a) component,” for retirement payments, and the “401(h) component,” for health supplement payments:

> <u>401(a) component:</u>
>
> The present value of the member’s future pension payments, reflecting his actual benefit commencement date, minus the present value of projected future payments that he would have received (according to Plan assumptions) if he had remained active and not received the incentive.
>
> <u>401(h) component:</u>
>
> The present value of the member’s future health supplement payments, reflecting his actual commencement date and election of coverage, minus the present value of projected future health supplement payments that he would have received (according to Plan assumptions) if he had remained active.

(*Id.*) “For each member” in an incentive program (i.e., ***everyone*** who participates), ASRS then aggregates “the 401(a) cost component and 401(h) cost component[]” “to give the total effect of the program on the member.” (*Id.*)

In broad strokes, the ASRS Policy requires calculating each member’s “active liability,” meaning the present value of retirement benefits if the member had not retired, as well as the “retired liability,” meaning the present value of

retirement benefits now that the member retired. (APP016 ¶ 20; APP133:17–APP134:21.) ASRS then calculates the charge to the employer as the "retired liability" minus "active liability." (APP155:18–APP156:1.) Reduced to a formula, Unfunded Liability = Retired Liability – Active Liability. ASRS then calculates these figures "for each member in the program," in other words, for every single participant. (APP312.)

Although the ASRS Policy implements and interprets § 38-749—and describes ASRS's procedural requirements for the statute—ASRS never promulgated the ASRS Policy pursuant to the APA's rulemaking requirements. (APP357 ¶ 14.) It has, however, "consistently" applied the Policy since its adoption. (APP214:5–12; *accord* APP022:20; *see also* APP405:8–9.)

By calculating the unfunded liability in this manner—and charging the employer the ***full*** unfunded liability "for each member in the program," the ASRS Policy assumes that 100% of participants in a termination incentive program retired solely ***because of*** the program. (APP312; *see* APP155:2–11.) Stated differently, ASRS assumes that but for a particular incentive program, no one who participated otherwise would have retired.

So, consider two employers, each of which has in a particular year 100 employees age 65 with 40 years of service (each with an assumed 30% chance of retiring). Suppose further that (a) one employer offers a modest (and completely

ineffective) termination incentive plan (e.g., a commemorative plaque and two movie tickets), (b) that the other employer does not, and (c) that 30 employees from each employer in fact retire that year. Under the ASRS Policy, ASRS would charge the employer with the incentive plan for an unfunded liability, but would charge the other employer nothing. (*See* APP218:8–24; APP219:25–10 (ASRS actuary testifying that if "folks had simply retired without an incentive, this amount of unfunded liability would be exactly the same," but that "[i]f it was determined that there was no incentive program, then there wouldn't have been a bill.").) Accordingly, although in both cases ASRS had, in effect, planned for 30 retirements from each employer, the ASRS Policy does not take that into account.

VI. The Complex Assumptions Underlying the ASRS Policy and Its Use of Unrealistic Assumptions for Certain Age/Service Groups

Although the ASRS Policy's underlying formula seems superficially simple, as ASRS's actuary explained, "[t]here is no simple formula" by which to calculate the unfunded liability. (APP168:7.) Indeed, to make the calculation, ASRS must rely on assumptions about interest rates, investment returns, salary increases, and more. (APP066:23–APP067:19.) It must also make detailed assumptions about the likelihood of a particular member retiring given the member's age and years of service. (APP326; APP147:11–20.) Every five years, ASRS then performs an "experience study" to see how its assumptions compared to its experience, which it

then considers in connection with revising its assumptions. (APP143:16–APP144:1.)

Pertinent to this case, ASRS conducted an experience study in 2007 at which time it examined the overall ratio of actual to expected retirements (i.e., the ratio of what had in fact happened during the past five years versus its assumptions). (*See* APP328–31; APP122:23–APP123:10, APP143:16–144:1.) (A ratio greater than 100% means that more members retired than the assumed rate.) Given the study, ASRS adjusted the assumptions such that the ratio decreased from 108.4% to 102.0% on an aggregate basis for all service and all ages combined. (APP 331; APP205:17–APP206:5.) Accordingly, it brought the overall ratio "closer to 100 percent," and therefore in the aggregate adopted assumptions that led to an assumed ratio that more closely matched its experience. (APP206:3–4.)

But for some decrements—particularly for individuals older than 65—ASRS adopted new assumptions that diverged further from reality. For example, for someone age 65 or older with 25 years of service, ASRS had been using a ratio of actual to expected retirements of 119.6%, a figure already significantly higher than 100%. (APP331.) But in 2007, rather than move the assumption closer to 100%, it adopted an assumption that resulted in a significantly higher ratio—169.8%. (*Id.*) This means that in 2007 ASRS began assuming that someone age 65 or older with

25 years of service had only a 25% chance of retiring, even though its experience had shown there was a 42.45% chance.[4]

Although ASRS began greatly underestimating the rate of retirement for this particular group, the ASRS Policy dictates that in computing the present values used in the formula, "the actuary will use the actuarial assumptions of the ASRS Plan." (APP312.) Consequently, although ASRS's assumptions "as a whole," may make sense, the ASRS Policy requires using the particular assumption adopted for a particular retiree, even though such assumptions may have no bearing to the unfunded liability resulting from that particular retirement.

VII. The Additional Charges ASRS Imposes for Health Supplements under the ASRS Policy

In addition to the unfunded liability for the retirement payments (the 401(a) component set forth in the ASRS Policy), ASRS performs a separate calculation for the health supplement payments (the 401(h) component), and in doing so likewise makes a number of assumptions that affect the charge to the employer. For example, ASRS retirees may select different types of health supplement payments, with some costing ASRS more than others. (APP111:18–112:13.) The ASRS Policy assesses a portion of the costs from some types of health

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[4] The ratio of actual to expected retirements is 169.8% (APP331) and ASRS estimates that 25% would retire (APP326). Therefore the percentage of actual retirements is 1.698 times the expected rate (25%), which equals 42.45%.

supplements, thereby assuming that a retiree selected a particular type of coverage because of the incentive. (APP156:2–4.)

Unsurprisingly, ASRS has found liability for every single termination incentive program it has evaluated. (APP217:21–24.)

VIII. ASU's Modest Incentive Program Offered to Retirement-Age Members

ASU participates as an employer in the ASRS defined benefit plan, and some of its employees are ASRS members. In 2011, ASU offered a Voluntary Separation and Retirement Incentive Program ("**Incentive Program**") to tenured faculty and academic professionals 60 years or older and with 10 or more years of service. The incentive was one year's worth of base salary with ***no*** adjustment to the Participant's salary. (APP271–99.) Unlike salary spiking plans, the Incentive Program thus did not increase the "average monthly compensation," A.R.S. § 38-749(D)(1), used to calculate the Participants' retirement benefits. (APP111:3–8 (ASRS's witness).) Accordingly, although the incentive would perhaps be sufficient to nudge someone who had already been considering retirement, the incentive would not be enough to cause most people to retire.

In fact, although offered to over 400 qualifying tenured faculty, only 72 of them (18 percent) participated, and only 17 of those were ASRS members (collectively, the "**Participants**"). All 17 Participants were already eligible for "normal" (as opposed to "early") retirement, meaning (1) age 65, (2) age 62 with

10 years of service, or (3) a combined age and years of service totaling 80. A.R.S. § 38-711(27)(a). Under ASRS's own assumptions, almost every Participant had at least a 30% chance of retiring in any event. *See* Table 2, *infra*. And, based on ASRS's own experience, many of those in fact had a much higher probability of retiring. (*See* Facts § VI, *supra*.)

At this time, and based on ASRS's assumptions, one would have expected a total of 252 ASU employees to retire in 2011, but only 215 did (17 of whom were Participants). (APP074:12–APP075:5; APP303-04.) The total number of ASU retirements during 2011 thus did not increase beyond the expected rate, and in fact came in below the assumed background rate of retirement used by ASRS. Consequently, the Incentive Program was, at best, only modestly successful, and it had no financial impact on ASRS. (APP085:21–APP086:16.)

IX. The Exorbitant $1.1 Million ASRS Sought to Charge for the Incentive Program

Pursuant to the ASRS Policy, ASU notified ASRS of the Incentive Program and its results. Given that only 17 employees participated—all eligible for normal retirement and most with a significant chance of retiring anyway—ASU was shocked when ASRS sent ASU an invoice for $1,149,103.

When ASU inquired about the exorbitant charge, it learned that ASRS had charged it $318,362 for just one individual (Irwin Sandler)—a nearly 67-year-old professor with more than 40 years of service. (*Id.*) For 69-year-old John Hall with

48 years of service, ASRS charged $148,000. (APP271.) And for 75-year-old Joseph Palais, ASRS charged for his health supplement even though it assumed there was a 100% chance he would have retired in that year without the Incentive Program. (APP171:10–20; APP307.)

X. The Administrative Appeal

ASU appealed the ASRS charge, arguing both (1) that the charge was void because ASRS violated the APA by failing to promulgate a rule, and (2) that ASRS's charge was contrary to law because ASRS assessed ASU for liabilities that were not the result of the Incentive Program. After an evidentiary hearing before the Office of Administrative Hearings, an administrative law judge denied the appeal. The administrative law judge found that (1) ASRS did not need to promulgate a rule because the statute did not expressly call for a rule (APP023:3–5), and (2) that ASRS's methodology is based upon accepted actuarial assumptions (APP022:13–14). The ASRS Board adopted the administrative law judge's decision with minor modifications. (APP264:11–APP265:1.)

ASU filed an action in the superior court for judicial review pursuant to A.R.S. §§ 12-901 to -913. (APP348.) ASU again argued that (1) ASRS's charge violated the APA because ASRS failed to promulgate a rule, and (2) that ASRS's charge violated A.R.S. § 38-749(A) because it assessed ASU for decisions that did not result from the Incentive Program. With virtually no discussion of the merits

of the case or ASU's arguments, the superior court affirmed the ASRS Board's decision. (APP005.)

ASU filed a timely notice of appeal on December 19, 2013. (R-33.) The superior court had jurisdiction under A.R.S. § 12-905(A). This Court has jurisdiction under A.R.S. § 12-913.

ISSUES ON APPEAL

1. The APA requires agencies to follow specific rulemaking procedures when promulgating rules. Without following those rulemaking procedures, ASRS created a rule that purports to determine an employer's liabilities for termination incentive programs. Are ASRS's actions void with respect to ASU because it acted contrary to law by failing to follow the APA's rulemaking requirements?

2. Under A.R.S. § 38-749, ASU is liable to ASRS only to the extent its termination incentive program "results in an actuarial unfunded liability." The ASRS Policy does not account for whether, or to what extent, an incentive program results in retirements that would not have otherwise occurred. Did ASRS improperly charge ASU for liabilities that were not the "result[]" of the Incentive Program?

3. ASRS may charge ASU only for the "actuarial unfunded liability" caused by the termination incentive program. The Incentive Program did not cause

the Participants' choice of health care supplements. Did ASRS act contrary to law by charging ASU for every Participant's choice in health care supplements?

STANDARD OF REVIEW

Whether an agency complied with the APA is a question of law that this Court reviews de novo. *See Phelps Dodge Corp. v. Ariz. Elec. Power Co-op., Inc.*, 207 Ariz. 95, 103, ¶ 16, 83 P.3d 573, 581 (App. 2004). The Court is also "free to draw [its] own legal conclusions in determining the proper interpretation of the applicable law." *Carondelet*, 182 Ariz. at 226, 895 P.2d at 138. An agency's action should be rejected if it "is contrary to law, is arbitrary and capricious or is an abuse of discretion." A.R.S. § 12-910 (E); *see also Havasu Heights Ranch & Dev. Corp. v. State Land Dep't of State of Ariz.*, 158 Ariz. 552, 555, 764 P.2d 37, 40 (App. 1988), *amended by* 173 Ariz. 159, 840 P.2d 1024 (questions of law and statutory interpretation must be "consider[ed] independently" by the appellate court).

ARGUMENT

I. ASRS's Action Is Void Because It Acted Contrary to Law by Implementing a Rule Without Complying With the APA and Charging ASU Pursuant to This Rule

The ASRS Policy satisfies the APA's definition of a rule, and as a result ASRS has acted contrary to law by attempting to charge ASU pursuant to a rule promulgated outside the requisite APA process. The ASRS Board's legal conclusion to the contrary disregards the APA's plain language and settled authority.

A. The APA Requires Agencies to Follow Specific Procedures for Promulgating a Rule

The APA broadly defines a "rule" as any generally applicable agency statement that implements a statute or describes agency procedure:

> "Rule" means an agency statement of general applicability that implements, interprets or prescribes law or policy, or describes the procedure or practice requirements of an agency.

A.R.S. § 41-1001(18). An agency must create a rule when, for example, a law "does not set forth the calculations to be made and leaves much to [the agency's] discretion." *Carondelet*, 182 Ariz. at 228, 895 P.2d at 140. In such circumstances, if a rule is not "promulgated in accordance with the provisions of the APA, . . . it is invalid." *Id*.

Among other things, the APA's provisions obligate the agency to create a public docket for the rule and publish a notice in the Arizona Administrative

Register, including the "exact wording of the rule." *See* A.R.S. §§ 41-1021, 41-1022. These notice requirements allow the public to meaningfully participate in the regulatory process. By statute, the public has a right to submit comments about the proposed rule and even call for an oral proceeding about the proposed rule. *See* A.R.S. § 41-1023(B)–(C). The agency must then consider the comments of the public, s*ee* A.R.S. § 41-1024 (C) ("[A]n agency shall consider the written submissions."), as well as the rule's economic impact, including a cost-benefit analysis. *See* A.R.S. § 41-1055. The agency must also maintain a complete record of this process in order to facilitate judicial review. *See* A.R.S. § 41-1029(A) ("An agency shall maintain an official rule making record.").

Following these procedures helps to create a transparent and fair regulatory process. Publication and accessibility of the rules prevents secret, backdoor rulemaking and ensures that affected members of the public, including employers such as ASU, are fully informed about their rights and obligations. Public participation in the process helps to ensure that the rules operate fairly and provides opportunities for others to point out deficiencies in the substance of the rules. In light of these goals, the Legislature created a "Regulatory bill of rights" "[t]o ensure fair and open regulation." A.R.S. § 41-1001.01(A). This bill of rights guarantees accessibility of rules, as well as the right to "participate in the rule making process." A.R.S. § 41-1001.01(A)(5), (6), (17).

B. ASRS Acted Contrary to Law by Charging ASU Pursuant to a Rule That It Adopted in Violation of the APA

After the Legislature enacted A.R.S. § 38-749, ASRS followed none of the required rulemaking procedures. It simply adopted a rule—the ASRS Policy—and did so even though it engaged in the type of policymaking the APA requires go through the rulemaking process.

ASRS executive staff met "to discuss how we were going to do our calculation of unfunded liability for early termination incentive offers . . . ." (APP191:13–19.) Recognizing that A.R.S. § 38-749 is by no means self-executing, ASRS considered various methods for calculating the liability it would charge employers. (APP191:20–21.) Ultimately, ASRS then adopted the "ASRS Policy on Employer Early Termination Incentive Programs," (APP311–12)—a document designed to "pin . . . down in writing" how ASRS would calculate the unfunded liability under A.R.S. § 38-749. (APP191:17–18.)

The ASRS Policy is and purports to be (1) "an agency statement of general applicability," that (2) "implements, interprets or prescribes law or policy, or describes the procedure or practice requirements of an agency." A.R.S. § 41-1001(18). It satisfies the first element because ASRS applies the Policy "consistently" to every employer termination incentive plan. (APP214:5–12; APP022:20; *see also* APP405:8–9 ("The current ASRS decision and calculation of employer termination program unfunded liability in this case has been the

consistent practice of the agency.”).) In other words, it is a “statement of general applicability.” A.R.S. § 41-1001(18); *cf. Carondelet*, 182 Ariz. at 227, 815 P.2d at 139 (“The first element is met since AHCCCS admits that its methodology is generally applied to all hospitals.”).[5]

The ASRS Policy satisfies the second element because the prescribed “methodology meets several of the independent criteria listed by the APA as defining a rule.” *Carondelet*, 182 Ariz. at 227, 815 P.2d at 139. It expressly “implements” a law—A.R.S. § 38-749. It also “interprets” the law by describing the particular methodologies used to calculate the fee it charges for the “actual unfunded liability.” *Cf. id.* (“The agency’s methodology employs rules of general application that determine the reimbursement levels for every hospital in Arizona.”). The ASRS Policy also “describes the procedure or practice requirements” because it prescribes the specific procedures for notifying the agency of an incentive program, what factual details must be submitted, how they will be transmitted, and the procedures for making payment. (APP311–12.)

To top it off, ASRS has all but conceded, as it must, that A.R.S. § 38-749 “does not set forth the calculations to be made and leaves much to [the agency’s] discretion.” *Carondelet*, 182 Ariz. at 228, 895 P.2d at 140. That is, the statute is

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[5] When *Carondelet* was decided, the definition of “rule” appeared at A.R.S. § 41-1001(12), rather than § 41-1001(18).

not self-executing. ASRS's actuary admitted that the statute "merely refers to the amount of the unfunded liability. It doesn't say how to calculate that." (APP212:25–APP213:4.) ASRS's actuary also admitted that the methodology set forth in the ASRS Policy is not required by actuarial standards: "The actuarial standards don't address how to calculate this unfunded liability. They're much more general." (APP213:20–APP214:4.) Presumably in light of this, ASRS candidly acknowledged below that "[i]f you asked a dozen actuaries how to calculate unfunded liability for an employer termination incentive program, you will get a dozen different options. We don't dispute that there are different ways to calculate this."[6] (APP263:18–23.)

ASRS thus could not and did not mechanically apply a methodology or calculation provided by the statute. Rather, ASRS interpreted the term "actuarial unfunded liability" as used in § 38-749, and in so doing it made policy decisions about what calculations to make and what factors to include. Accordingly, ASRS's implementation of the "Policy" and its specified "methodology . . . meets the definition of a rule, which must ordinarily be promulgated in accordance with the APA." *Carondelet*, 182 Ariz. at 227, 895 P.2d at 139.

[6] ASRS has since tried to retreat from this argument by suggesting that alternate methods would not be accurate. (APP404.) For the reasons that follow, ASRS's methodology does not accurately calculate the unfunded liability. Whether there are multiple viable methods or just one, ASRS's assessment is contrary to law because ASRS did not correctly interpret the statute.

C. Contrary to the ALJ's Conclusion, Legislative Silence on Rulemaking Requires Promulgation of a Rule

The ALJ concluded that because A.R.S. § 38-749 "does not require ASRS to adopt a rule," ASRS need not do so. (APP023:3–5; *see also* APP401:6–8 (arguing that the "absence" of language requiring it to adopt implementing rules "indicates that a rule was not necessary in implementing the statute.").) But this legal conclusion ignores the APA's rulemaking mandate and runs directly contrary to *Carondelet*.[7]

By statute, the APA and its rulemaking mandate "apply to all agencies and all proceedings not expressly exempted." A.R.S. § 41-1002(A). This background principle applies even when the Legislature does not expressly require rulemaking to enact a particular statute, as *Carondelet* confirms. In *Carondelet*, AHCCCS argued that "it can be inferred from [the statute's] silence that the legislature never envisioned the need for an explanatory rule." *Carondelet*, 182 Ariz. at 228, 895 P.2d at 140. This Court stated "we disagree." *Id.* As *Carondelet* correctly explained, under A.R.S. § 41-1002(A), "[a]ll agencies are subject to the APA ***unless*** they are expressly exempted." *Id.* (emphasis added). In other words, the

[7] The ALJ also concluded that "to require ASRS to promulgate a rule is not practical given that the assumptions change." (APP023:5–6.) But a rule need not itself contain any assumptions, as the ASRS Policy demonstrates. The ALJ's other conclusion—that "[t]he statutory language is unambiguous and sufficient to guide ASRS's actions in determining whether an early termination incentive program results in an unfunded liability and in what amount" (APP023:7–9)—is likewise belied by the ASRS Policy and the statute's language.

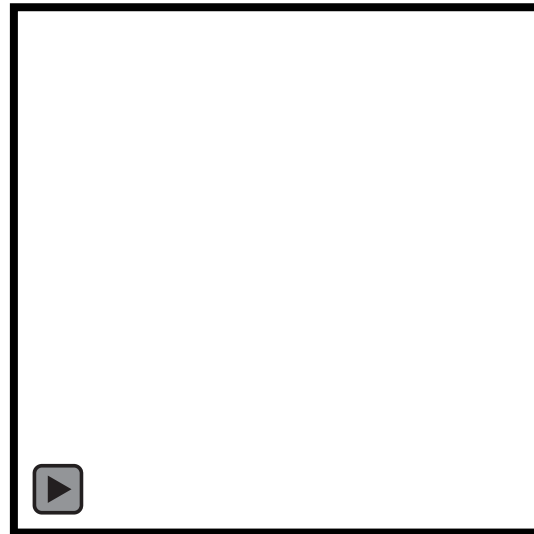
ALJ got the significance of a statute's silence backwards; an agency directive like § 38-749 that is not self-executing requires an implementing rule ***absent*** some express statutory language to the contrary.

In addition, in this case ASRS went ahead and adopted a generally applicable statement concerning the methodology ASRS uses to implement § 38-749—a rule. In light of that, it cannot avoid the APA merely because of the "absence" of language requiring it to adopt a rule. *Cf. Sw. Ambulance, Inc. v. Ariz. Dep't of Health Servs.*, 183 Ariz. 258, 262, 902 P.2d 1362, 1366 (App. 1995) (superseded by statute on other grounds) ("The point to be made is that whenever a regulatory order is promulgated that includes anything that is properly the subject of a rule, the rule-making process must be followed.").

ASRS's own conduct confirms it understands this principle. Pursuant to its statutory authority to adopt "rules for the administration of the plan," A.R.S. § 38-714(E)(4), ASRS has promulgated several rules to implement statutes that likewise said ***nothing*** about rulemaking. *E.g.*, A.R.S. § 38-740 (implemented by A.A.C. R2-8-115); A.R.S. § 38-762 (implemented by A.A.C. R2-8-115); A.R.S. § 38-737 (implemented by A.A.C. R2-8-122).

Recognizing that it must comply with the APA's rulemaking provisions in such situations, ASRS even considered requesting a general exemption from APA rulemaking. (*See* APP450 ("Administrative Procedures Act (Rulemaking)

Exemption: Exempt the ASRS from the requirements in the Administrative Procedures Act and, instead, institute a Board process for Rulemaking." (emphasis omitted)).) And, in connection with § 38-749 specifically, ASRS, at its rule writer's request, asked the Legislature to temporarily exempt it from the otherwise applicable rulemaking requirements. (APP441:25–APP442:3.) The original bill specified that "the Arizona state retirement system is ***exempt*** from the rule making requirements of title 41, chapter 6, Arizona Revised Statutes, for eighteen months after the effective date of this act." (APP316 (emphasis added).) An amendment to the bill struck that exemption, thereby re-subjecting ASRS to the rulemaking requirements. (APP319.) When asked whether re-subjecting ASRS to the rulemaking requirements would cause ASRS any "heartburn," the ASRS Deputy Director of External Affairs responded "[w]e have no heartburn over" it. (APP441:20–APP442:7; *see* audio clip (adjacent).)



This history confirms the Legislature (and ASRS) knew that it had to expressly exempt ASRS from rulemaking in order to excuse the agency from its obligations under the APA. The limited duration of the original exception

(eighteen months) further demonstrates that the Legislature always intended ASRS to promulgate a rule in compliance with the APA, but—originally—just not right away. The amendment striking the exemption demonstrates that the Legislature wanted ASRS to promptly promulgate a rule. Because the APA's rulemaking provisions govern unless "expressly exempted," A.R.S. § 41-1002(A), the statute required no additional language to subject it to rulemaking. Simply put, unless and until the Legislature exempts ASRS from the APA, it must comply with the governing rulemaking procedures, even if it would rather not do so.

Duke Energy Arlington Valley, LLC v. Arizona Dep't of Revenue, 219 Ariz. 76, 193 P.3d 330 (App. 2008), upon which ASRS relied below, does not suggest a different rule, and in fact confirms that ASRS is wrong in this case. *Duke* considered whether "tables" referenced in a statute governing the valuation of electric generation facilities were "rules" subject to the APA or guidelines. 219 Ariz. at 77, ¶ 6, 193 P.3d at 331. The parties disputed whether the statute expressly referred to the tables as "guidelines," but the court found that under the statute's plain language "[t]he ***legislature*** . . . designated the tables as 'guidelines.'" *Id*. at 78, ¶ 10, 193 P.2d at 332 (emphasis added). Furthermore, as *Duke* explained, that the statute "refers to the tables as guidelines, and not rules, is clearly an indication that the legislature intended these tables to function as guidelines, and not rules." *Id*. ¶ 11. The Court further noted that the Legislature has used the term "rules" in

other statutes governing the Department of Revenue, but it did not cite this to suggest that only statutes requiring rulemaking do so. Rather, it confirmed the Legislature knows the difference between a "guideline" and "rule." *Id.* Consistent with *Carondelet* and other precedent, *Duke* thus teaches that when the "legislature [has] made clear" that rulemaking is not required, rulemaking is not required. *Id*. at 79, ¶ 12, 193 P.2d at 333. But mere silence will not do.

D. ASRS's Other Arguments for Its Failure to Follow the APA Do Not Withstand Scrutiny

In addition to the flawed argument accepted by the ALJ, ASRS argued below that it could nevertheless implement the ASRS Policy without complying with the APA because (1) cases like *Carondelet* involved different statutory language and a more complex methodology, (2) the ASRS Policy is no more than an "internal guideline," and (3) the nature of its "fiduciary" obligations make § 38-749 inappropriate for rulemaking. (APP400–05.) These arguments, however, likewise do not withstand scrutiny.

1. Contrary to ASRS's Contention, This Case, Like *Carondelet*, Involves a Statute That Was Silent on Rulemaking and Involves Complexity

In the proceedings below, ASRS sought to distance *Carondelet* on two grounds: (1) the law at issue in *Carondelet* referenced "rules adopted," whereas this statute is silent on rules; and (2) *Carondelet* involved a "complex calculation,"

whereas this case involves a "conceptually simple arithmetic formula." Neither distinction withstands scrutiny.

(a) The Statute in *Carondelet* Did Not Expressly Require the Rules at Issue in the Case

Carondelet addressed AHCCCS's failure to promulgate a rule for the methodology it used to adjust factors that would in turn be used to determine hospital payment rates. *See* 182 Ariz. at 226, 895 P.2d at 138. ASRS argued below (APP448) that *Carondelet* does not apply because the law at issue in that case referenced "rules adopted" and referenced another statute that required rules, whereas the law at issue here contains no such references.

But the court did not rely on these oblique references when it required AHCCCS to promulgate rules. Quite the opposite; the court relied on legislative ***silence***. It expressly rejected the argument that silence suggests that the Legislature did not envision rules, and reaffirmed the statutory principle that "[a]ll agencies are subject to the APA unless they are expressly exempted." *Id.* at 228, 895 P.2d at 140. The section heading for that discussion confirms the major thrust of the holding: "The Legislature Did Not Exempt AHCCCS from the Requirements of the APA." *Id.*

When the court identified two references to "rules," it explained that the references "***bolstered***," or confirmed, the conclusion it had already reached. *Id.* (emphasis added). If the law at issue had expressly required rules for the

methodology AHCCCS used, then it would have been an easy case. But it did not. Rather, a different subsection of the law authorized the agency to waive compliance with the session law or any "rules adopted pursuant to this section." *Id.*; *see also* 1989 Ariz. Sess. Laws 1st Reg. Sess., Ch. 293, § 22(F). The law also "refer[ed] to" specific "levels" from another statute, and the other statute included a rulemaking requirement. 182 Ariz. at 228, 895 P.2d at 140. The court did not read these references to require the rules that were at issue in the case, nor could it. Rather, the references suggested that the Legislature had rules on its mind—as it did in promulgating this statute, given that the Legislature initially contemplated an 18-month rulemaking exemption. Once again, ASRS gets it backwards. The references to rules in different subsections and a different statute did not require the rules in *Carondelet*. Rather, legislative silence did, as it does here.

(b) To the Extent It Matters, ASRS Employs a Complex Methodology to Calculate the Unfunded Liability

Carondelet considered a law that required AHCCCS to use total charges and volume levels from hospitals to adjust payment rates in order to maintain a baseline rate level. *See* 182 Ariz. at 224, 895 P.2d at 136. AHCCCS argued that it was not required to promulgate a rule because calculating rate changes was simple "bookkeeping." *Id.* at 227, 895 P.2d at 139. This Court disagreed. The statute did not prescribe a simple calculation; developing the specific methodology required

the agency to make decisions about what should be included. *Id.* at 227-28, 895 P.2d at 139-40. AHCCCS had to properly promulgate a rule.

As a threshold matter, ASRS's suggestion that the complexity of the underlying math matters is incorrect. If an agency adopts a rule that satisfies the definition set forth in A.R.S. § 41-1001(18), then generally it must comply with the rulemaking requirements. Here, the formula set forth in the ASRS Policy—"Retired Liability" less "Active Liability"—is nowhere found in § 38-749. Nor is it encompassed within the plain meaning of "actuarial unfunded liability" because that term has no plain meaning. The formula ASRS adopted involved policy choices concerning how to implement the law (and as demonstrated below indefensible ones at that).

More fundamentally, however, ASRS's suggestion that this case, unlike *Carondelet*, involves a "simple arithmetic formula" is misleading. Many superficially-simple seeming formulas in fact involve tremendous complexity. $E=mc^2$, for example, is not an equation that reveals all its subtlety in the few symbols that it takes to write down. Similarly, Arizona's Form 140 tax due equation (tax due (line 35) equals tax balance (line 27) minus tax payments and credits (line 34)) masks the underlying complexity of those terms. In reality, calculating the components requires substantial work: what constitutes income,

what deductions and credits are available, and what are the conditions and requirements for them?

Here, saying that unfunded liability is simply the “active liability” minus the “retired liability” masks that calculating both of these figures involves complicated actuarial calculations; the calculations appear as little more than a black box to employers such as ASU.

Calling the formula “simple” also glosses over that ASRS made various policy decisions about what components to include (i.e., it engaged in rulemaking). For example, it chose to include the participants’ selected forms of payment in the components, and it added additional liability for the participants’ health supplement selections. These components appear nowhere in the statute and no actuarial principles demand that they be included when calculating “actuarial unfunded liability.” ASRS then had to determine how to compute the payment and healthcare values, which involved still more discretion. For example, ASRS decided to use the participants’ selected health supplement only for two years. (APP183:17–19.)

Thus although the unfunded liability is determined ***after*** calculating the “active liability” and “retired liability,” determining the values to input into each component of the formula is anything but simple. Determining each component requires substantial additional complex calculations. Presumably for this reason,

when ASRS's actuary was asked if "there is a simple formula that you can get to me as a layperson to calculate how you derived" the unfunded liability, he acknowledged, "Well no. There is no simple formula." (APP168:3–7.) Because the law is not "self-executing" and is not "a universally recognized formula," ASRS must promulgate a rule. *Carondelet*, 182 Ariz. at 227-23, 895 P.2d at 139-40; *see also Ariz. Soc'y of Pathologists v. Ariz. Health Care Cost Containment Sys. Admin.*, 201 Ariz. 553, 557, ¶ 21, 38 P.3d 1218, 1222 (App. 2002) (affirming requirement of rule when statute "is not patently clear").

2. The ASRS Policy Is Not Merely a Guideline

ASRS's suggestion that the ASRS Policy is an internal "guideline," rather than a rule under A.R.S. § 41-1001(18) is likewise meritless. To distinguish between "rules" and "guidelines" courts have focused on whether the underlying methodology implements a statute (a rule), or instead is used in consideration with other statutorily prescribed data. *Duke*, for example, emphasized that the Department of Revenue used the tables (the guidelines) as merely "the first element in determining the value of the personal property" subject to the taxpayer "submit[ting] documentation showing the need for . . . an additional adjustment . . . ." 219 Ariz. at 79, ¶ 15, 193 P.3d at 332. The tables were thus "not a complete implementation of the statute . . ." *Id.* Similarly in *Canyon Ambulatory Surgery Ctr. v. SCF Arizona*, 225 Ariz. 414, 239 P.3d 733 (App. 2010), the fee

methodology at issue was "merely a way to collect data to be considered in setting reimbursement amounts, in the exercise of the [agency's] discretion." *Id.* at 420, ¶ 23, 29 P.3d at 739. In other words, the agency "simply uses the information provided to guide its reimbursement decisions." *Id.*

In this case, the ASRS Policy is not merely a prescription for a formula that ASRS considers along with other data to determine the amount of the resulting "unfunded liability." It sets forth a rule: "The actuary ***will determine*** . . . the unfunded liability . . . as follows:" (APP311 (emphasis added).)

3. ASRS's Fiduciary Obligation Does Not Excuse It from the Rulemaking Process

ASRS's suggestion below that the nature of its fiduciary obligations somehow make rulemaking inappropriate is misplaced. As the name of the Administrative Procedure Act implies, the APA prescribes procedure, not substance. *See* A.R.S. § 41-1002(B) (APA "creates only procedural rights and imposes only procedural duties."). The APA and the associated notice-and-comment rulemaking processes do not tie ASRS's hands as to its substantive policy choices. They do not affect its ability to stay true to any of its fiduciary obligations.

For these reasons, this Court has repeatedly faced and rejected the argument that following the APA would tie an agency's hands and prevent it in some way or another from accomplishing its substantive policy goals. *See, e.g.*, *Carondelet*, 182

Ariz. at 229, 895 P.2d at 141 ("We further disagree with AHCCCS' contention that forcing them to promulgate a rule would '***tie their hands***' and not allow them to fulfill the statutory mandate to promptly correct ABC adjustments without lengthy rulemaking and protracted public hearings and industry input." (emphasis added)); *Havasu Heights*, 158 Ariz. at 560, 764 P.2d at 45 (rejecting argument that "requiring the department to promulgate rules governing holding leases would '***tie its hands***' and prevent it from treating each lease on an individual basis" (emphasis added)). ASRS's fiduciary obligations provide no excuse for failing to follow the APA.

ASRS seems to believe that following the APA would let the fox guard the henhouse. But decades of experience with the APA prove otherwise. Under the APA, ASRS would notify the public of its proposed implementation of A.R.S. § 38-749. Affected parties, such as ASU and other employers, could then submit comments to the agency and, if requested, call for an oral proceeding. *See* A.R.S. § 41-1023(B)–(C). ASRS would then have to ***consider*** the employers' comments, A.R.S. § 41-1024(C), but it would not have to follow them. If, however, ASRS had followed the APA, then ASU and other employers could have identified the problems associated with ASRS's methodology and could have proposed alternatives that accurately account for the "actuarial unfunded liability" and give full force to the statute. But regardless of any comments, the text of A.R.S. § 38-

749 guarantees that ASRS complies with any fiduciary obligations because it requires that an employer reimburse ASRS for any "actuarial unfunded liability" caused by a termination incentive program. Any rule ASRS properly promulgates would—unlike the ASRS Policy—have to satisfy that requirement.

E. ASRS's Failure to Follow the Rulemaking Requirements Voids Its Actions

"A rule is invalid unless it is made and approved in substantial compliance with" the APA. A.R.S. § 41-1030(A). Accordingly, ASRS had no authority to charge ASU pursuant to that rule, and accordingly must refund the unlawful charge. *See Carondelet*, 182 Ariz. at 230, 895 P.2d at 142 ("AHCCCS ***must compensate the hospitals*** for all claims for which reimbursement was reduced by the application of the unauthorized methodology." (emphasis added)); *see also id.* at 228, 895 P.2d at 140 ("Because no rule was promulgated pursuant to the APA, any changes in the ABC factor as a result of the charges and volume reports are void."); *Havasu Heights*, 158 Ariz. at 561, 764 P.2d at 46 (restoring *status quo ante* and discussing available remedies); *see also Phelps Dodge*, 207 Ariz. at 127, ¶ 141, 83 P.3d at 605 ("[A]s [agency] actions taken pursuant to invalid rules, the . . . decisions are void, and the superior court correctly vacated them in their entirety.").

II. Pursuant to Its Legally Flawed Policy, ASRS Acted Contrary to Law by Charging ASU for Liabilities That Did Not Result from the Incentive Program

Although § 38-749 is not self-executing, it does impose some substantive limits on what ASRS may do. In particular, under § 38-749, ASU is liable to ASRS only to the extent its Incentive Program "results in an actuarial unfunded liability." Under the plain language of the statute, ASRS may not charge an employer for liabilities it would have incurred regardless of any incentive program. Consequently, any rule adopted by ASRS must take into account the fact that some individuals will retire each year regardless of any incentive program. As several examples show unequivocally, however, ASRS as a matter of "policy" fails to do that.

A. A.R.S. § 38-749 Permits ASRS to Charge Employers Only for Any Additional Unfunded Liabilities Caused by a Termination Incentive Program

1. Section 38-749's Language and Purpose Show ASRS May Charge Employers Only for the Additional Unfunded Liabilities Caused by a Termination Incentive Program

"[A] statute must be given a sensible construction that accomplishes the legislative intent behind it." *Am. Family Mutual Ins. Co. v. Cont'l Cas. Co.*, 200 Ariz. 119, 122, ¶ 17, 23 P.3d 664, 667 (App. 2001) (citations omitted). In this case, A.R.S. § 38-749(A)'s plain language makes an employer liable to ASRS only to the extent a termination incentive program "***results in*** an actuarial liability to ASRS." A.R.S. § 38-749(A) (emphasis added). In other words, (1) the early

termination program must ***cause*** some ***additional*** increase in ASRS's expected liabilities in order for ASRS to charge the employer, and (2) the employer is liable only for the ***additional*** amount resulting from the termination incentive program. *Id*. Unsurprisingly, this is precisely how ASRS explained HB 2052 to the Legislature when it was introduced. (*See* APP431 (the statute "[s]tates that if an employer implemented retirement incentive program ***creates*** an unfunded liability to ASRS, that employer shall pay the amount of the unfunded liability to ASRS." (emphasis added)); *see also* APP436:7–11 ("This bill would set forth that any employer that offers a retirement incentive program which ***causes*** an unfunded liability on the system, that the employer would have to pay the difference and pay for the unfunded liability." (emphasis added)).)

Construing § 38-749 to permit ASRS to charge only for a liability that would not exist but for the incentive program—the "result[ing]" liability—is also the only construction of § 38-749 that makes sense. The Legislature passed § 38-749 to preclude employers from unfairly shifting to ASRS liabilities that it would not otherwise incur. It rests on principles of basic fairness: one employer ought not be able to shift to other employers and employees the cost of funding a particular individual's retirement. (*See* APP438:17–19 ("It is intended to stop the unfunded liability coming back on all the other employers and employees.").)

If, however, ASRS may charge an employer who offers a termination incentive program for liabilities that ASRS would otherwise incur, then ASRS would be unfairly shifting to one employer—the employer with an incentive program—liabilities for which ASRS had already planned. If that occurs, then ASRS, in effect, would be penalizing employers who offer incentive programs, and creating disincentives to offer such programs contrary to the Legislature's intent.

2. An Example of Two Similarly Situated Employers Confirms That ASRS May Charge Only for Additional Unfunded Liabilities Caused by a Termination Incentive Program

Properly construed, therefore, § 38-749 obligates ASRS to take into account the liabilities that it would incur in any event, and charge only for the unfunded liabilities, if any, that would not exist but for the incentive program. This is critical because "anything of value"—from a $25 gift card to large lump sum payment—triggers potential liability under § 38-749.

For example, suppose Employer A offers 200 employees, all of whom qualify for normal retirement, a termination incentive program. Under Employer A's incentive program, any employee who retires within twelve months would receive a lump sum $25 gift card and a commemorative plaque. (For simplicity's sake, assume that the difference between each employee's "active liability" and "retired liability" is $100,000.) Suppose further that ASRS expects that 30% of these employees would retire without the incentive, and 60 of them (30%) do in

fact take the incentive and retire. In other words, no one retired because of the incentive, and thus the incentive program did not cause any unfunded liabilities.

Another employer, Employer B, offers 100 similarly situated employees a similar termination incentive, except that the incentive is a lump sum $500,000 payment. Again, ASRS expects that 30% of these employees would retire in any event. Suppose 60 of them (60%) do in fact take the incentive and retire. In other words, the incentive program caused twice as many employees to retire than otherwise would have without the incentive, and accordingly resulted in a significant unfunded liability (30 × $100,000, or $3 million).

In this scenario, as depicted below in Table 1, the same number of employees retired from both employers (60 for each). But Employer A, which offered a modest payment, did not realize any unexpected retirements, and therefore did not cause any unfunded liabilities. Employer B, on the other hand, offered a significantly larger payment and saw double the expected retirement rate. As a result, Employer B created a large unfunded liability. (*Cf.* APP086:17–APP087:18 (similar example); APP218:8–24 (another similar example).)

Under these circumstances, ASRS should not charge Employer A for any unfunded liability because the incentive program did not create any unfunded liability. In addition, ASRS would plainly violate § 38-749 if it charged both Employer A and Employer B the ***same*** amount merely because the same number of

employees retired from each employer. After all, Employer B's program resulted in a significant unfunded liability to ASRS, but Employer A's program did not. Yet, as explained below, under ASRS's construction of § 38-749 set forth in the ASRS Policy, ASRS would charge both employers $6 million ($100,000 for each of the 60 retirees)—an incorrect amount for ***both*** employers. This means ASRS's interpretation violates A.R.S. § 38-749, and ASRS violated the statute when it charged ASU $1,149,103 for the 17 ASRS members who participated in the ASU Incentive Program.

Table 1: Example with Two Employers.

Employer	**Eligible employees**	**Expected retirements**	**Actual retirements**	**Unfunded Liability**	**Charge using ASRS Policy**
A	200	60	60	$0	$6 million
B	100	30	60	$3 million	$6 million

B. Under the ASRS Policy, ASRS Charges Employers for the Full Liability of Every Employee Who Participates in an Incentive Program, Regardless of Whether the Incentive Program Resulted in Any Unfunded Liabilities

ASRS regularly calculates for each active member "the liability attributable to that active member based on all of the probabilities . . . for retirement, disability, death, [and] termination." (APP140:19–23.) Accordingly, in connection with calculating the present value of liability for active members (a figure it then uses to determine employer and employee contributions), ASRS makes detailed

assumptions about the likelihood of these events, including the probability of a particular member retiring given the member's age and years of service. (APP326; APP147:11–20.) For example, ASRS assumes that a 60-year-old with 20 years' of experience has a 35% chance of retiring. (APP326; APP147:21–24.)

ASRS then uses these assumptions and other data to calculate the contributions necessary to fund the expected retirements. So, for example, if there were 100 ASRS members with a 30% chance of retiring, ASRS must collect sufficient funds to fund the expected 30 retirements in a given year. (*See*, *e.g.*, APP062:23–APP065:19; APP082:8–15.) And, precisely because ASRS plans for a certain percentage of retirements each year, those retirements by design do not result in any additional unfunded liabilities (so long at the assumptions are reasonable). (*Cf.* APP218:8–APP220:10 (ASRS actuary explaining that for employees who retire without an incentive plan, ASRS can perform the same calculation—retired liability minus active liability—but if there is "no incentive program, then there wouldn't [be] a bill.").)

Although ASRS uses those assumptions when calculating the "active liability" component of the charge, it ignores them when determining whether an incentive program resulted in any unexpected or excess retirements. Instead, ASRS charges the employer "for each member in the program" (i.e., ***everyone*** who accepts the incentive) (APP312), and thus it implicitly assumes that 100% of

participants in an incentive termination program retired ***because of*** the program, and, conversely, that not a single participant would have retired otherwise. (*See* APP155:2–11; APP220:1–10.) This means that the ASRS Policy does not limit itself to the unfunded liability that results from an incentive program. It charges without regard to whether (and to what extent) the incentive actually works, and therefore violates A.R.S. § 38-749.

C. Contrary to Law, ASRS Charged ASU for Retirements Not Caused by the Incentive Program

Unsurprisingly, in applying its flawed methodology to ASU, ASRS grossly overcharged ASU in violation of A.R.S. § 38-749. Indeed, every one of the 17 Participants in the ASU Incentive Program qualified for normal retirement, with many of them over 65. *See* A.R.S. § 38-711(27)(a) (defining normal retirement); (APP077:24–APP078:2). It would thus be shocking if, but for the Incentive Program, no one other than 75-year-old Joseph Palais would have retired in 2011. Yet that is precisely what ASRS assumed, and it did so even though under its own (flawed) assumptions ASRS expected that almost all of the Participants had at least a 30% chance of retiring.

Table 2 shows the ASRS assumed retirement probability for each of the 17 Participants, based upon their age and years of service.

Table 2: Retirement probability for each Participant.[8]

Name	Age	Service	ASRS Charge	Retirement Probability
Russell Biekert	72.31	11.99	($2,135)	22%
Jay Butler	65.49	38.99	$110,292	30%
Maria Cardelle-Elawar	73.07	23.61	$10,551	35%
Lee Croft	64.65	37.87	$53,636	33%
Frank Davis	65.86	37.59	$80,359	30%
Allan DeSerpa	66.3	32.8	$74,170	30%
Eugene Garcia	65.07	15.19	($14,703)	30%
Steven Golen	63.41	33.95	$143,013	33%
John Hall	69	37.87	$143,629	30%
Stephen Hefner	63.85	37.99	$48,689	33%
Leslie Irwin	65.65	15.87	$4,272	30%
Leonard Montenegro	60.53	24.99	$18,269	35%
Joseph Palais	75.28	46.87	$0	100%
Irwin Sandler	66.8	40.87	$311,936	30%
Louis Smith	73.33	39.87	$35,564	22%
Victor Teye	62.03	26.87	$46,460	25%
Guoliang Zeng	67.43	17.85	$19,614	30%

Because ASRS followed the ASRS Policy (i.e., the rule it adopted without complying with the rulemaking requirements), ASRS used these probabilities when calculating the cost of early retirement for each participant. However, it then ignored these same probabilities when determining whether the Incentive Program resulted in any unexpected retirements. Instead, ASRS assumed that no

[8] The retirement probabilities come from the table at APP326. The remaining numbers come from APP307.

Participants would have retired without the Incentive Program—i.e., that the Retirement Probability for each was zero. In other words, ASRS ignored the very background retirement rates it uses for its general planning purposes. As a result, rather than charge ASU for the marginal difference in liabilities, ASRS charged ASU as if every single one of the Participants would not have retired but for the Incentive Program. Charging ASU in this manner violates A.R.S. § 38-749(A) because it results in charges for liabilities that are not the "result[]" of the Incentive Program.

Although in the proceedings below ASRS suggested that it did not overcharge ASU, the example in Argument § II.A.2 shows that ASRS's methodology treats all incentive programs the same, and thus does not consider whether an incentive program caused ASRS to incur a liability it did not expect, and if so the amount of that unexpected liability. Another example—concerning the nearly 67-year-old Irwin Sandler who retired with more than 40 years of service—confirms it overcharged ASU in this case due to this same underlying flaw in its methodology. In this case, ASRS determined that the difference between Dr. Sandler's liabilities as an active member and as a retired member totaled $311,936. (*See* Table 2, *supra*; *see also* APP307.) That is, he cost ASRS $311,936 more as a retired member than as an active member. Or, said another

way, ***if he had retired sooner than he otherwise would have***, then the additional cost to ASRS would be $311,936.

But under the very assumptions ASRS used in this case for determining that value, ASRS expected that there was about a 0.300, or 30%, chance that Dr. Sandler would have retired in that year ***without*** an incentive program. (*See* Table 2, *supra*; *see also* APP326; APP223:14–18.) This means that if 100 members shared Dr. Sandler's age and service, ASRS expected that thirty of them would have retired in 2011 ***without any incentive***. But under the methodology ASRS used to charge ASU, if there were 100 Dr. Sandlers, and 30 of them retired ***just as ASRS expected*** (i.e., the incentive program did not result in any additional liability to ASRS), ASRS would still assess the $311,936 on ***all 30*** members, for a total of more than $9.3 million.

Although there were not 100 Dr. Sandlers, the analogy demonstrates the fundamental flaw in ASRS's methodology as applied to ASU. ASRS implicitly assumed that the Incentive Program caused the retirement of the real Dr. Sandler (100%), despite the 30% chance that he would have retired anyway. As a consequence, it charged ASU the whopping $311,936 for a 66.8-year-old with more than 40 years of service. ASRS did the equivalent thing for every eligible member who retired in 2011, even though every single one of them had a nonzero chance of retiring in 2011 without the Incentive Program. Thus, ASRS failed to

take into account the probability that members would have retired anyway. Said another way, ASRS charged ASU for all of the actuarial liability for all eligible members who retired in 2011, even though the Incentive Program did not "result[] in," or cause, all of it given ASRS's own assumptions. A.R.S. § 38-749(A).

ASRS admits as much. ASRS's actuary confirmed that if Dr. Sandler was the ***only*** ASRS member who retired from ASU in 2011 (in other words the incentive program was worse than a complete failure), then ASRS would still charge ASU the full $311,936—even though he had a 30% chance of retiring, and even though ASRS expected several more retirements based upon its assumptions:

> Q. Let me ask you this. Let's assume that ASU had offered this voluntary retirement incentive plan, and the ***only person*** who accepted it was Erwin Sandler, who was age 66 and had over 40 years of service. ASRS would have billed ASU for $318,362;[9] is that correct?
>
> A. ***Yes***.

(APP228:11–16] (emphases added).) He also confirmed that if the 17 Participants had retired without an incentive, then the retired liability minus active liability calculation would have been "exactly the same," but "there wouldn't have been a bill." (APP219:25–APP220:10.)

To top it off, when ASU's actuary Ms. Nicholl compared the ASU retirement rate to ASRS's assumptions, she found that 37 fewer ASU employees

[9] The $318,362 includes a $6,426 charge for Dr. Sandler's health supplement selection, which is discussed in Argument § III, below.

retired in 2011 than ASRS expected. (APP074:21–APP075:3.) This finding is consistent with the conclusion that the Incentive Program did not result in any unfunded liability. Section 38-749, however, permits ASRS only to charge for the liability resulting from the Incentive Program. By failing to take into account ASRS's own assumed background retirement rate, ASRS violated § 38-749.

D. Neither the Administrative Law Judge Nor the Superior Court Confronted the Central Issue

Although ASU argued before the administrative law judge and the superior court that ASRS's assessment is contrary to law because it fails to limit the charge to the "results" of the Incentive Program, A.R.S. § 38-749(A), neither judge confronted this central issue. The administrative law judge found that ***if*** a member retires early, then the early retirement creates unfunded liability:

> The evidence demonstrated that when a member retires prior to the time that ASRS assumes that member is going to retire based upon its actuarial assumptions, such retirement results in an unfunded liability because the member is no longer active and contributing to ASRS, and ASRS must pay the member a pension.

(APP022:15–19.)

This finding, however, like ASRS's analysis, overlooks the causation requirement of A.R.S. § 38-749(A) and simply ***assumes*** that the Incentive Program caused all of the retirements—an assumption ASRS knows is inaccurate. In fact, it assumes that because (1) ASRS can calculate the difference between a member's retired and active liability, and (2) ASRS labels this the "resulting unfunded

liability" for everyone who participates in a termination incentive program (but no one else who retires), then that figure is the liability resulting from the incentive program. But declaring that figure the resulting liability does not make it so; that figure only could be the resulting unfunded liability if the incentive program ***caused*** the retirement. The findings, therefore, implicitly rest on an incorrect interpretation of § 38-749.

The administrative law judge also noted that ASU's concern "is one which should be addressed to the legislature." (APP023:2.) But the Legislature already spoke to this issue. It enacted a statute limiting employers' liability to the "results" of a termination incentive program. ASRS must follow the text of the statute as written.

The superior court issued a boilerplate ruling that failed even to acknowledge the issue. The court summarized the procedural history and standards of review, and then simply concluded, "This Court concludes the authorities and arguments provided by the ASRS are well-taken, and this Court adopts those authorities and arguments in support of its decision." (APP007.) The superior court did not address the merits at all.

E. ASRS's Remaining Justifications Do Not Withstand Scrutiny

1. Zero and Negative Values Do Not Justify ASRS's Methodology

ASRS assessed zero pension cost for one participant and negative values for two participants. ASRS suggested below that these zero and negative values show the soundness of its methodology. They do not. ASRS still assumed that the Incentive Program caused all three retirements.

One Participant was over 75 years old, so ASRS assumed that he had a 100% chance of retiring in 2011. ASRS still implicitly assumed that ASU's Incentive Program caused that retirement, but assigned zero value to the retirement because in actuarial terms he was no more expensive as a retired member than as an active member (i.e., his "active" liability component equaled the "retired" component). This situation is analogous to a breach of contract with zero damages. *See, e.g.*, *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y. 1921).

Similarly, two Participants imposed lower actuarial liability when retired than when active. *See* Table 2, *supra*. Even though ASRS assumed a 22% and 30% chance that these two members would have retired without an Incentive Program, ASRS still assessed the difference to ASU. Although the negative valuation benefitted ASU for those two participants, ASRS still applied a faulty methodology. The fact that three Participants have zero or negative values does not validate ASRS's methodology.

2. That ASRS Applied Its Standard Assumptions Does Not Save the Faulty Interpretation and Application of A.R.S. § 38-749(A)

ASRS also claimed that it is immune from attack because it used the same assumptions and valuations as it uses to administer the plan and which have been validated by experience studies. Setting aside that the assumptions ASRS used for many of the Participants grossly underestimated their retirement probability, this argument misses the point because the assumptions do nothing to show that ASRS properly followed A.R.S. § 38-749(A) in determining whether ASU's Incentive Program "result[ed] in an actuarial unfunded liability."

The statute calls for a determination of whether an action by an employer caused actuarial unfunded liability. ASRS assumed causation and jumped straight to determining the value of all actuarial unfunded liability caused by the retirements, without regard to what portion—if any—the employer caused. ASRS's assumptions do not call for that improper interpretation of the statute.

3. Correctly Interpreting A.R.S. § 38-749 Would Not Impose Burdens on ASRS or Other Employers

ASRS's contention below that failing to charge ASU the full $1,149,103 liability would unfairly shift the liability to "the general ASRS contributing population," (APP399:23–25), gets it exactly backwards. ASRS seems to believe that because a particular employee's participation in an incentive program changes "the probability that an individual employee would retire . . . from x% to 100%,"

and the contribution rates only paid for the x%, ASRS must charge an employer the full difference between 100% and x% to avoid overcharging other ASRS members. (APP388:20–25.) This, however, is also demonstrably false.

By design, the contributions ASRS collects should cover the expected retirements each year. So for example, if by 2011, ASRS expected to have 100 members at age 65 with twenty years of service, it would have collected contributions sufficient to fund 35 retirements because it uses a 35% probability for this decrement. If 35 members retired in 2011, then necessarily those retirements would have no future impact on employer contributions because ASRS's assumptions matched reality. For this reason ASRS does not bill for employees who retire without an incentive, even though the unfunded liability calculation for all retired members is "exactly the same." (*See* APP220:1–10.)

Returning to the example of Employer A (Argument § II.A.2), in that circumstance ASRS would have collected contributions sufficient to fund the expected 60 retirements. The fact that Employer A offered an incentive program did not change that. Accordingly, by charging Employer A the full difference between 100% and 30%, as would ASRS, would shift to Employer A costs for retirement that it and the retiring members had already paid for with contributions. In other words, it would be overcharging Employer A to the benefit of other employers. And, the overcharge may be so significant—as this case

demonstrates—that ASRS is, in effect, making incentive programs cost prohibitive. That is not what § 38-749 contemplates.

III. ASRS Likewise Violated § 38-749 in Connection with the Charges for Health Supplements

For the reasons set forth in Argument § I, ASRS's calculations for the Participants' health supplements also violates § 38-749. That is, ASRS may not assess health supplement charges for Participants who would have retired anyway. (*See also* APP085:14-20.) But these calculations are also improper because they penalize ASU for choices made by retirees, rather than assessing any unfunded liability caused by the Incentive Program. Although health supplements, properly calculated, may be an appropriate charge for Participants whose retirements were caused by the Incentive Program, in no case may ASRS charge ASU for the higher costs of a particular health supplement selected by a Participant.

Yet that is just what ASRS did. It charged ASU for the health supplements selected by the retirees, even though the Incentive Program had nothing to do with the Participants' health supplement choices. Pursuant to A.R.S. § 38-783, eligible retirees may elect to receive healthcare supplements either through ASRS or through an employer-sponsored plan; alternatively, the member may decline health coverage. For example, the member may choose single or family coverage. In addition, some members are eligible for Medicare. (APP129:10–15.)

The member's choice and circumstances affect the costs to ASRS. Ordinarily, when an ASRS member retires, the employer is not charged (or refunded) anything based on the employee's health supplement. In this case, however, for every Participant ASRS charged ASU for the difference in liability between what ASRS expected for that Participant's health supplement and what the Participant actually selected.[10] In other words, if a Participant selected an expensive health supplement option, ASU got hit with the bill even though in the absence of an incentive program it would not. ASRS assessed health supplement charges for ***every*** Participant, as shown in Table 3 below.

[10] Because members may change the health supplement election, ASRS used the costs for the elected supplements for two years. (APP183:15-20; APP335.) This two-year period has no impact on the analysis because charging ASU even for two days of elected coverage has no basis in A.R.S. § 38-749.

Table 3: Health Supplement Charge for each Participant.[11]

Name	Retirement Probability	Health Supplement Charge
Russell Biekert	22%	$3,757
Jay Butler	30%	$1,267
Maria Cardelle-Elawar	35%	$1,781
Lee Croft	33%	$5,527
Frank Davis	30%	$6,460
Allan DeSerpa	30%	$3,165
Eugene Garcia	30%	$2,944
Steven Golen	33%	$6,442
John Hall	30%	$4,474
Stephen Hefner	33%	$6,052
Leslie Irwin	30%	$3,081
Leonard Montenegro	35%	$4,060
Joseph Palais	100%	$1,747
Irwin Sandler	30%	$6,426
Louis Smith	22%	$1,146
Victor Teye	25%	$6,256
Guoliang Zeng	30%	$902

These charges are not permitted under A.R.S. § 38-749(A). ASRS may only charge ASU for liabilities that "result[]" from the Incentive Program. A.R.S. § 38-749(A). In addition to the failure to take into account the background retirement rate, ASRS should not have charged ASU for the Participants' choice of plans because the Incentive Program did not "result[] in" those choices.

[11] The retirement probabilities come from the table at APP326. The remaining numbers come from APP307.

Joseph Palais, for example, was over 75 years old when he retired. ASRS assumes that all members would have retired by that age. His retirement probability was 100%, and his pension cost was zero. *See* Tables 2 and 3, *supra*. ASU should have no liability whatsoever for Dr. Palais's retirement because it is undisputed that the Incentive Program did not cause his retirement. ASRS, however, charged ASU $1,747 for his health supplement. ASRS calculated his health supplement as $9,263 as a retired member, but only $7,516 as an active member. (APP172:5–11.) Dr. Palais's own decision to choose a more expensive option caused this difference, not the Incentive Program. In other words, there is no basis for ASRS to assume that Incentive Program somehow caused Dr. Palais to select different healthcare than he otherwise would have.

The same is true for all of the other Participants. The health care supplement costs for all members should be zero because the Incentive Program did not cause or "result[] in" the Participants' selections. It makes no sense—and is contrary to law—to charge ASU for costs that have nothing to do with the Incentive Program.

IV. Properly Assessing Any Actuarial Unfunded Liability Caused by a Termination Incentive Program Would Not Impact the Solvency of ASRS

ASRS has taken the position in litigation that its methodology is necessary to ensure the soundness of ASRS. Not so. Properly interpreted and applied, A.R.S. § 38-749 ensures that termination incentive plans will not adversely impact

ASRS. In fact, the statute guarantees that a termination incentive program will have zero actuarial impact because it requires employers to pay ASRS for any unfunded liability a termination incentive plan causes. Improperly attributing retirements to ASU, as ASRS has done, unfairly burdens and penalizes ASU by requiring it to overcompensate ASRS.

Moreover, a ruling against ASRS in this case would not subject ASRS to a flood of litigation about past charges. It would apply only to ASU, or at most very recent assessments.[12] Prospectively, ASRS would have to promulgate rules in accordance with the APA and develop a methodology that properly accounts for the background rate of retirements. By definition, any proper methodology would fully compensate ASRS for any unfunded actuarial liability and would have no adverse impact on ASRS's finances.

REQUEST FOR FEES ON APPEAL

Pursuant to ARCAP 21, A.R.S. §§ 12-348(A)(2), § 41-1007(E), and 12-341, Appellant requests its fees and costs incurred on appeal.

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[12] Employers must seek judicial review within 35 days; older assessments against employers would not be eligible for review. *See* A.R.S. § 12-904(A).

CONCLUSION

For these reasons, this Court should vacate the judgment of the superior court, vacate ASRS's actions, and order that ASRS refund to ASU $1,149,103 plus interest.

RESPECTFULLY SUBMITTED this 22nd day of April, 2014.

OSBORN MALEDON, P.A.

By: /s/ Thomas L. Hudson

Thomas L. Hudson
Eric M. Fraser
2929 North Central Avenue, Suite 2100
Phoenix, Arizona 85012

ARIZONA BOARD OF REGENTS, for and on behalf of ARIZONA STATE UNIVERSITY
Lisa K. Hudson
Associate General Counsel
P. O. Box 877405
Tempe, Arizona 85287-7405

Attorneys for Plaintiff/Appellant