

The following information was recently provided to NYSTRS' participating employers. As a Retirement System delegate, it is important you are aware of these issues.

## **Delegate News**

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### **Court Decisions Upholding the Retirement System's Three-Year Final Average Salary Determinations**

Today, most System members are Tier 2, 3 or 4 members with a membership date on or after July 1, 1973. Their retirement benefit is calculated using a three-year final average salary.<sup>1</sup> Tier 1 members (those with a date of membership prior to July 1, 1973) may also have their benefit calculated using a comparable three-year final average salary, unless the five-year final average salary calculation would provide a better benefit.<sup>2</sup>

The compensation which may be included in the three-year final average salary calculation is limited to "regular compensation" and may not include any form of lump sum termination payment, payment for unused leave, fringe benefit, or other payment in anticipation of retirement or to induce retirement.

The System vigilantly guards against any efforts to get compensation into the three-year calculation that does not belong and the courts of New York have been entirely supportive of the System's enforcement of the three-year calculation as provided under statute. Participating employers and their legal counsel should be aware the courts uphold System determinations excluding various items of claimed "regular compensation" from the three-year calculation.

Following is a summary of a key court decision on this topic and how the principles upheld in this decision have had a broad impact on other relevant cases. Recipients of this bulletin are urged to share it with their employer's legal counsel.

#### ***The Holbert Decision***

*Summary:* Non-Regular Compensation Cannot Be Converted to Regular Compensation on the Eve of Retirement

The recent decision of the Appellate Division of the New York State Supreme Court in *Holbert v. New York State Teachers' Retirement System*, 43 A.D.3d 530 (3d Dep't 2007), demonstrates the courts' support for System determinations excluding questionable payments from the three-year final average salary calculation.

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<sup>1</sup> As provided in sections 443(a), 512(a) and 608(a) of the Retirement and Social Security Law and Sections 5003.1 and 5003.4 of the System's Rules and Regulations, as applicable.

<sup>2</sup> Tier 1 five-year final average salary calculations are governed by Education Law §501(11)(a), subject, in the case of Tier 1 members with a date of membership on or after June 17, 1971, to the limitations of section 431 of the Retirement and Social Security Law. A discussion of what may or may not be included in the five-year calculation is beyond the scope of this bulletin.

In *Holbert*, the Appellate Division upheld the System's determination to exclude certain raises in a member's base annual salary from the member's three-year final average salary calculation. In earlier employment contracts, the member had been entitled to an employer contribution to a tax sheltered annuity, as well as certain other cash fringe benefits. In subsequent contracts, those items disappeared from the member's contract while, at the same time, the member received a 30% raise in base salary.

When calculating the member's three-year final average salary, the System reduced the member's raise in that year to a raise in line with the next highest percentage raise received by an administrator in that school district. This adjustment in base salary then flowed through the System's calculation of the member's base salary for the succeeding years until the member's retirement. The member challenged the System's determination, seeking to have \$69,274 added into his three-year final average salary calculation.

While upholding the System's determination, the Appellate Division affirmed a number of the principles applied by the System when excluding compensation from a member's three-year calculation:

1. The System is not bound by how the parties may label a transaction and may look at the substance of that transaction.
2. The three-year calculation may not include payments made in anticipation of retirement or which artificially inflate the member's final average salary.
3. Payments which represent compensation over and above base compensation, such as employer contributions to tax sheltered annuities and other fringe benefits, are not regular compensation.

The court in *Holbert* held the System could reasonably conclude, when applying these interrelated principles to the circumstances of the member's case, that the 30% raise the member received should not be included in the calculation of the member's three-year final average salary and, further, the System could recalculate the member's base compensation, using a reasonable assumption that the member would otherwise have received a raise in line with the next highest percentage raise for administrators.

### ***Legal Principles Upheld in the Holbert Decision***

The principles upheld the *Holbert* decision can be found in many other court decisions which have sustained System determinations. A look at the principles and the cases in which they are reflected follows.

#### **1. The System's Right to Determine the Substance of a Transaction**

Employers sometimes argue that the System should be bound by the provisions of agreements they have entered into with their employees and should accept such provisions without question, even when they purport to increase the employees' base salary on the eve of retirement or convert items of non-regular compensation into regular compensation. The System has and will continue to reject such arguments. As the court stated in *Roloff v. Langlitz*, [unreported decision] (Supreme Court, Albany Co. November 30, 1984), the System "...sits as the watchdog guarding its funds for the well-being of all of its members."<sup>3</sup> As the "watchdog" over System funds for the benefit of all members, the System will examine contract provisions carefully to determine whether the compensation they provide may properly be included in the three-year

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<sup>3</sup> A copy of an unreported decision cited in this Bulletin may be obtained from the System's Legal Department upon request.

calculation. The courts of New York have repeatedly upheld the power of the System to look through to the substance of employer agreements. *See e.g. Davies v. New York State and Local Police & Fireman Retirement System*, 259 A.D.3d 912 (3d Dep't), *lv. to app. denied*, 93 N.Y.2d 810 (1999).

For example, in *Cooper v. New York State Teachers' Retirement System*, 19 A.D.3d 734 (3d Dep't 2005), the Appellate Division upheld the exclusion of a substantial raise granted to a retiring member on the eve of his retirement. The employer had claimed the raise was to compensate the member for assuming the duties of a departed employee. However, that employee had left in 1997 and the raise was only granted to the member in the 2000-01 school year. According to the Appellate Division, "...it was not irrational for [the System] to conclude that the disproportionate increase in salary was given in anticipation of retirement despite the school district's protestations to the contrary..."

In *Moraghan v. New York State Teachers' Retirement System*, 237 A.D.2d 703 (3d Dep't 1997), the Appellate Division rejected a retiree's argument that the System should not be permitted to infer an exchange of the retiree's right to receive a payment for his accumulated unused sick leave for an unusual increase in his base compensation in the absence of a contractual provision expressly providing for that exchange. The Appellate Division stated: "...we are of the view that [the System] could rationally conclude from all of the evidence in the record that [the retiree] received substantially larger than usual pay increases in the terminal contract in exchange for his waiver of the right to be compensated for the 101 days of previously accumulated sick leave..."

## 2. The System's Right to Exclude Eve of Retirement Payments

As the System is a defined benefit plan, the pensions provided to its members are necessarily funded pursuant to calculations that incorporate certain actuarial assumptions. Chief among those assumptions is the expectation that the salary earned during the three-year final average salary period is reasonably representative of career salaries. The inclusion of payments which are not representative of a teacher's compensation for actual teaching service performed during the teacher's career is potentially harmful to the actuarial soundness of the System and, therefore, such payments cannot be included in the three-year calculation.

The courts have repeatedly upheld System determinations excluding increases in compensation outside of the ordinary course which are paid on the eve of retirement. In *Miller v. New York State Teachers' Retirement System*, 157 A.D.2d 890 (3d Dep't 1990), the Appellate Division upheld the System's determination to exclude "extra work incentive bonus" payments fixed at 10% of a member's salary which were only available to teachers with at least 17 years of service and within 3 years of the minimum age to retire. In *Martone v. New York State Teachers' Retirement System*, 105 A.D.2d 511 (3d Dep't 1984), the Appellate Division upheld the System's determination to exclude bonuses available to members with 20 or more years of service and equivalent to 30% of one year's salary. In *Simonds v. New York State Teachers' Retirement System*, 42 A.D.2d 470 (3d Dep't 1973), the Appellate Division upheld the System's determination to exclude so-called "terminal leave pay" which took the form of a 12% increase in the member's salary upon submission of his notice of retirement to his employer. In *Holly v. New York State Teachers' Retirement System*, 122 Misc.2d 871 (Sup. Ct., Albany Co. 1984), the Supreme Court upheld the System's determination to exclude one-time purported longevity payments which served to inflate the member's salary by 14% in one school year and 16% in another school year. In *Nencetti v. Vrooman*, [unreported decision] (Supreme Court, Albany Co. May 13, 1977), the court upheld the System's decision to exclude a retroactive "salary adjustment" approved at the time the member resigned his position.

### 3. The System's Right to Exclude Elements of Non-Regular Compensation

The courts have upheld System determinations that foil attempts to convert items of non-regular compensation into regular compensation. In *Moraghan v. New York State Teachers' Retirement System*, 237 A.D.2d 703 (3d Dep't 1997), the Appellate Division upheld the System's determination to exclude substantial increases in the member's base compensation which the System had determined were granted in exchange for the member foregoing his right to receive a payment for his accumulated unused sick leave. In *Adler v. New York State Teachers' Retirement System*, 188 A.D.2d 732 (3d Dep't 1992), the Appellate Division upheld the System's determination to exclude a substantial increase in the member's base compensation which he had negotiated with his employer in exchange for giving up his right to receive a large lump sum termination payment.

#### ***Other Considerations***

#### The Courts Will Uphold the System's Decisions, When Reasonable

Employers and their counsel should also be aware of the ground rules under which any challenge of a System determination would be considered. Education Law §509(9) provides that no court review of a final determination of the System may be had except pursuant to Article 78 of the New York Civil Practice Law and Rules. In any proceeding pursuant to Article 78, System determinations will be upheld so long as they are not arbitrary or capricious. *Holbert v. New York State Teachers' Retirement System*, 43 A.D.3d 530 (3d Dep't 2007); *Holly v. New York State Teachers' Retirement System*, 122 Misc.2d 871 (Sup. Ct., Albany Co. 1984).

#### Availability of the System's Legal Department to Respond to Counsel's Inquiries

The System's Legal Department is available to respond to questions from employers and their counsel regarding the laws and rules governing System benefits and how the System will approach individual benefit determinations. Any advice provided with respect to proposed specific transactions, however, will necessarily be subject to the System's review of the transactions at retirement based upon the record before the System at that time.