U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

OPINION 80-28A
404(a)(1)(A), 408(b)(2)

MAY 7 1980

Mr. William J. Nellis
Coghlan, Joyce and Nellis
Fortieth Floor
One North LaSalle Street
Chicago, Illinois 60602

Re: Central States, Southeast and Southwest Areas Pension Fund
Identification Number: F-1412A

Dear Mr. Nellis:

This is in response to your request for an advisory opinion dated November 23, 1979, supplemented by letter dated February 12, 1980, on behalf of the Trustees (the "Trustees") of the Central States, Southeast and Southwest Areas Pension Fund (the "Fund"). You have requested the opinion of the Department of Labor (the Department) under the Employee Retirement Income Security Act of 1974 ("ERISA") concerning certain issues relating to the compensation being paid by the Fund to Victor Palmieri and Company Incorporated ("VPCO"), an investment manager employed by the Trustees pursuant to two agreements (more fully described below), and concerning the effect and lawfulness of certain provisions in those agreements.

In your original submission dated November 23, 1979, you posed three questions. In your latest submission dated February 12, 1980, you have amplified and modified your earlier request. At present, you seek an opinion on the following five questions. First, you inquire whether the Trustees are obliged to remain in continuous compliance with the ERISA requirement to pay "no more than reasonable compensation" to VPCO out of plan assets. Next, you ask whether the compensation currently being paid to VPCO by the Fund is "more than reasonable compensation". Third, you inquire whether, under the circumstances described in your request, a refusal by VPCO to enter into negotiations for a reduction of its rate of compensation would provide "cause" for termination by the Trustees of the appointment of VPCO. Fourth, you ask whether, under the circumstances, a refusal by VPCO to enter into negotiations for reduction of its rate of compensation would provide "cause" for unilateral contract fee modification by the Trustees. Finally, you ask whether the contractual requirement of written consent by the Secretary of Labor to any termination or unilateral modification by the Trustees of the appointment of VPCO is valid and enforceable.

The opinion which follows addresses the five questions presented. It should be noted, however, with regard to your second inquiry, that the question of whether compensation being paid in a specific case is "reasonable" under ERISA depends upon the facts and circumstances of each case. Ordinarily, the Department does not give its opinion on questions which are inherently factual. See ERISA Advisory Opinion Procedure section 5.01 (ERISA Proc. 76-1, 41 FR 36281). Similarly, the Department would not ordinarily issue an advisory opinion regarding the scope of private contractual obligations under specific contractual provisions. However, as you indicated in your submission, the Department was significantly involved in the events which led to the appointment of VPCO and others as independent investment managers for the Fund. In that context, the parties explicitly provided in their contract for the Department to play a continuing role in providing assistance to the Trustees of the Fund and to the investment managers of the Fund with respect to matters arising under the agreements appointing the managers,[1] and the Department indicated to the parties that it was prepared to play such a role. In keeping with its expressed intention, the Department has determined to provide guidance to the Trustees regarding all the questions raised.

The materials submitted on behalf of the Trustees contain extensive information concerning the events leading up to the appointment of VPCO as investment manager for the Fund. Those materials indicate, generally, that both the Department and the Trustees reached agreement that the Trustees would select and appoint reputable independent professionals to assume responsibility for management of the Fund's assets, and that this was considered to be essential for the protection of the Fund. To achieve this objective, the Trustees participated in negotiations extending over a period of several months with candidates for management of the real estate-related assets of the Fund. The materials you have submitted indicate that in addition to VPCO, at least fourteen firms expressed an interest in being appointed to manage the real estate assets of the Fund. The materials also indicate that the terms of VPCO's compensation were the subject of negotiation between the Trustees and VPCO.

The two agreements governing VPCO's appointment are a "Master Agreement" and an "Investment Management Agreement". These agreements are dated June 30, 1977, and are signed by the Trustees, the Equitable Life Assurance Society of America ("Equitable") and VPCO. Under Article I of the Master Agreement, the Trustees appointed Equitable as named fiduciary of the Fund, with responsibility for, among other things, developing and implementing investment objectives and policies, and allocating available investment funds among several investment managers. Available investment funds include, with certain limitations, new contributions, the income from real estate-related assets, and the proceeds from the sale of any such assets. Pursuant to Article II of the Master Agreement, the Trustees appointed several different investment managers to manage different assets of the Fund. The Trustees appointed

[1] See Article XIII of the Master Agreement.

VPCO as investment manager for all of the Fund's real estate-related assets located west of the Mississippi River.

Under section 12.02 of the Master Agreement, the Trustees undertook to pay VPCO a recurring annual fee in accordance with the Investment Management Agreement. Under section 6.02 of the Investment Management Agreement, this fee was fixed on the basis of the value of the assets initially given to VPCO to manage. In addition, under section 6.03 of the Investment Management Agreement, VPCO was given authority to arrange for the provision of specified supplemental services at the cost of the Fund. The duration of the appointments and of the agreements is governed by Article IX of the Master Agreement. That Article provides as follows:

> "9.01 Amendments of Trust Agreements.
> Prior to the Closing Date the Trustees shall amend the Trust Agreement of the Fund to provide for the appointment of Equitable as Fiduciary and Equitable and VPCO as independent investment managers in the manner contemplated by this Agreement (the "Trust Amendment"). Such appointment in the Trust Amendment may not be terminated, changed, modified, altered or amended in any respect prior to the expiration of five years from the Closing Date except for cause and upon:
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>> (i) The delivery of not less than sixty days' prior written notice to each of the Sectary of Labor (the "Secretary"), the Commissioner of Internal Revenue (the "Commissioner"), Equitable and VPCO, specifying in detail the cause for and nature of the proposed termination, change, modification, alteration and amendment; and
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>> (ii) the written consent thereto by the Secretary, on behalf of the Department of Labor, within such sixty-day period, or such additional period as may be agreed upon by the Secretary and parties to this Agreement.
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> 9.02 Termination or Alteration of Status or Contractual Terms. Except as set forth in §9.01 hereof, neither the status of Equitable as Fiduciary and investment manager, nor the status of VPCO as investment manager, nor the contractual terms of either this Agreement or any Investment Management Agreement for services by Equitable or VPCO as an investment manager, may be terminated, modified or amended, except in accordance with the following
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>> (a) For a period of five years after the Closing Date, there shall be no such termination, modification or amendment unless (i) there is consent thereto by Equitable or VPCO, as the case may be, and (ii) there is no need to modify the Trust Amendment …."

Prior to the closing of the agreements, the parties requested, and the Department issued, a series of advisory opinions[2] and exemptions[3] relating to the legality of the agreements, including the legality of the fee provisions. Among the representations made to the Department in connection with one of the exemptions were representations as to the necessity of the services to be provided and the reasonableness of the compensation to be paid. Public notice of the proposed exemption, including a summary of these representations, was published in the Federal Register, comments were requested and a public hearing was held. The reasonableness of the compensation was not questioned and the exemption was granted by the Department on the basis of the representations made.

You indicate that, even if the contractual provisions relating to VPCO's compensation were deemed reasonable at the time they were entered into, subsequent developments have caused the Trustees to question the continuing reasonableness of VPCO's fee. In this regard, you allege that certain estimates made by VPCO regarding the number of staff to be assigned to the account have proven inaccurate; that there has been a reduction in the amount of assets being handled by VPCO;[4] that VPCO has made generous use of outside counsel under the clause in the Investment Management Agreement permitting such supplemental services to be charged to the Fund; and that the fee provides VPCO large profits.

Your first inquiry concerns the Trustees' obligation to comply with ERISA requirement to pay no more than reasonable compensation to VPCO. Section 404(a)(1) of ERISA provides, in relevant part, that:

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[2] Advisory Opinions 77-60/61A, 77-62/63A, 77-64/65A, 77-66/67A, 77-68A, 77-69/70A, 77-78A, 77-79/80A, and 77-81A.

[3] Prohibited Transaction Exemptions 77-11 and 77-12.

[4] When VPCO was appointed as investment manager by the Trustees, the precise amount of the portfolio to be held in real estate-related assets was undetermined. Pursuant to section I.06 of the Master Agreement, the proper amount was to be decided by Equitable. Further, as noted in Advisory Opinion 77-62/63A, at the time the agreements were entered into, it "appear[ed] likely … that Equitable [would] determine that the Fund should move in the direction of investing a larger portion of its portfolio in investments that [were] not real estate-related …." You inform the Department that on September 20, 1978, Equitable reported to the Trustees that it had determined an appropriate goal at that time would be to reduce real estate assets to not more than 25 percent of total Fund assets. As a result, all income from real estate-related assets handled by VPCO has been transferred to Equitable to be reinvested in securities-related assets. In addition, the proceeds from the sale of real estate assets by VPCO have been transferred to Equitable for reinvestment. You state that Equitable reported that the percentage of assets invested in real estate was approximately 32 percent as of September 30, 1979.

> "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -- (A) for the exclusive purpose of … (ii) defraying reasonable expenses of administering the plan…."

It is the Department's view that the Trustees are under a continuous obligation to comply with this, as well as all other applicable sections, of the Act.[5]

With respect to your second question, the Department has carefully reviewed the factual aspects of your submissions[6] to determine whether the fee being paid VPCO may have become unreasonable under the circumstances. It is the Department's opinion, based on the submissions, that no conclusion that the contractually provided fee to VPCO has become unreasonable is warranted at this time.

In making its determination, the Department has attached some weight to the unusual circumstances which produced the arrangements for investment management that were made in this case and to the circumstances under which those arrangements were made. In particular, the Department has considered the fact that the five year contracts for real estate management which are terminable only for cause were negotiated by the Trustees with the investment managers so as to provide assurance that the appointed managers would have a maximum degree of independence in all decisions pertaining to the real estate-related assets of the Fund; that such assurance was considered a particularly important goal in the circumstances of this case; and that only the contracts can provide this assurance. The Department has also taken into consideration the fact that no evidence has been submitted indicating that these contracts were unreasonable under the circumstances existing at the time the contract were entered into, and no claim has been made that VPCO subsequently violated the terms of the contracts. Nor does it appear that

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[5] Your query with respect to the reasonableness of compensation was cast in terms of the applicability of the exemption provided by section 408(b)(2) from the prohibitions of section 406. The reasonableness of the compensation under section 408(b)(2) is addressed below.

[6] In a submission to the Department dated January 4, 1980, VPCO disputed some of the Trustees' representations, and made certain additional representations of its own relating to the legality of the fee. The Department does not view the advisory opinion procedure generally as providing an appropriate forum for the resolution of disputed questions of fact. To the extent that there are propositions of fact that are essential to the resolution of the questions presented in a request for an advisory opinion, and are not answerable with sufficient certainty on the basis of the record presented, the Department will ordinarily decline to issue an opinion. See section 5.01 of the Advisory Opinion Procedure, supra. While the extensive submissions you have made and the submissions of VPCO demonstrate that there are some matters of fact as to which you and they are not in agreement, the Department has determined that all the ultimate facts material to the resolution of the questions presented are essentially uncontroverted. The factual propositions on the basis of which this opinion is given are identified in the text.

the expectations of the parties with respect to the amount of assets under VPCO's management, at the time the fee was negotiated, have been materially frustrated.[7] Finally, the Department has considered the fact that no information has been submitted to show that a comparably reputable, independent professional firm might charge under comparable circumstances, and no other objective standard has been suggested pursuant to which the continuing reasonableness of the fee could be fairly gauged. In light of these considerations, the Department is of the view that the materials submitted on behalf of the Trustees do not support a finding that the fee being paid VPCO has become unreasonable under the circumstances.

In your submission on behalf of the Trustees, you inquire as to the reasonableness of the fee not only under section 404(a)(1) of ERISA, but also under section 408(b)(2) of the Act. Section 408(b)(2) of ERISA provides that:

> "(b) The prohibitions of section 406 shall not apply to…
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> > (2) Contracting or making reasonable arrangements with a party in interest … if no more than reasonable compensation is paid therefor."

It is not necessary at this time to decide whether the prohibitions of section 406 apply to the contract entered into between VPCO and the Trustees. Even if those prohibitions should apply, the exemption provided in section 408(b)(2) would be available insofar as the compensation paid under those arrangements is reasonable.

The answer to the second question you raised regarding the reasonableness of the compensation being paid to VPCO disposes of your third and fourth questions, which relate to the effects of VPCO's asserted refusal to enter negotiations with respect to the fee. Assuming, without deciding, that it would be "cause" under the contract between VPCO and the Trustees for VPCO

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[7] It appears from certain statements in your current submissions that the Trustees may take the view, for purposes of this advisory opinion request, that there was not, at the time the investment management agreements were entered into, a mutual understanding that the Fund's real estate-related assets were to be materially reduced. As you know, the Department was an active observer and to some extent a participant in the negotiations leading to the investment management agreements. As a result of that activity, the Department is aware that a significant consideration in the structure of the contractual fee for VPCO was the dissociation of the fee from the value of the assets that might be under VPCO's management subsequent to the closing of the agreements, so as to eliminate both the possibility and the possible appearance that VPCO might be disinclined to dispose of the real estate-related assets on account of considerations related to the fee. That VPCO might effect a material reduction in the Fund's real estate-related assets was clearly contemplated. (See also footnote 4, supra, in this regard.) Accordingly, the Department has construed the Trustees' contentions with respect to this matter as assertions that the Trustees did not contemplate or did not fully comprehend that the reduction in the real estate-related assets under management by VPCO would be as extensive as it has in fact been.

to decline to negotiate with respect to a fee which had become unreasonable, in the absence of such a development no "cause" for termination or modification appears.[8]

With respect to your final question, whether the requirement of "written consent" by the Secretary of Labor to any termination of the appointment of VPCO as investment manager of the Fund is valid and enforceable, the Department is aware of no provision in ERISA or any other law that would preclude the Secretary from performing his designated role under the contract between VPCO and the Trustees. Accordingly, the Department is of the opinion that the contractual provision regarding termination is valid and enforceable.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 thereof relating to the effect of advisory opinions.

You have asked for a conference in the event the Department contemplated issuing an adverse opinion. The Department has determined to advise you of its opinion without providing the occasion for such a conference, for a number of reasons. It is the policy of the Department to schedule a conference, if one has been requested, only if the Department determines that a conference would be necessary or appropriate in deciding the matter. See Advisory Opinion Procedure section 8. The Department has carefully reviewed the submissions with a view to determining whether a conference would be necessary or appropriate and has concluded that it would not. You have made it clear that your request for a conference is limited to a request to confer with respect to factual matters and does not extend to a conference on the legal questions presented. As indicated in footnote 6, supra, the Department does not view the Advisory Opinion Procedure as a suitable mechanism for the resolution of disputed factual issues, and in that connection, has concluded that a conference relating to the factual controversies presented would not be appropriate, or helpful.

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[8] As set forth in the text, the provisions of Article IX of the Master Agreement specify the circumstances under which modifications may be made in the arrangement for the services of the investment managers and the circumstances under which such arrangements may be terminated prior to the expiration of the contracts. That Article provides that, absent agreement among the parties, the appointments can only be terminated or modified for cause and with the consent of the Secretary of Labor. This Department does not understand that the Trustees now claim to have "cause" within the meaning of the Master Agreement for the termination or modification of the investment management arrangement involving VPCO. Accordingly, the Department does not construe its action with respect to this advisory opinion request as being of any significance under section 9.01 of the Master Agreement. Should the Department receive information from the Trustees to the effect that they propose to terminate or modify the investment management arrangement with respect to any of the managers "for cause", the Department will proceed accordingly. If a factual determination should appear to be required, the Department will provide an appropriate fact finding mechanism to discharge its responsibilities.

Sincerely,

Alan D. Lebowitz
Assistant Administrator for Fiduciary Standards
Pension and Welfare Benefit Programs