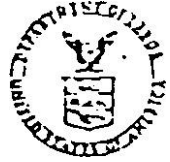


U.S. DEPARTMENT OF LABOR
Pension and Welfare Benefit Programs
Washington, D.C. 20016



OCT 3 1977

OPINION 77-78 A

Paul S. Berger, Esq.
Arnold & Porter
1229 Nineteenth Street, N.W.
Washington, D.C. 20036

3(26)
404(a)(1)

Dear Mr. Berger:

In response to your letter of August 31, 1977,
and the exhibits attached thereto, we have written
our answer on the enclosed photocopy of your letter.
By doing this we are able to avoid having to recite
or summarize the facts you have set forth in your
letter.

In future correspondence please refer to our
Reference No. C-3796A.

Sincerely,

Fred W. Stuckwisch
Director, Office of Regulatory
Standards and Exceptions

ARNOLD & PORTER

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WASHINGTON, D.C. 20036

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295

PAUL S. BERGER

DIRECT LINE (202) 872-6784

August 31, 1977

Advisory Opinion
Office of Regulatory Standards
and Exceptions
Pension and Welfare Benefit Programs
U.S. Department of Labor
Washington, D.C. 20216

Re: Request for Advisory Opinion Submitted
by Victor Palmieri and Company Incorporated -- Valuation

Gentlemen:

Enclosed is a request for an advisory opinion that Victor Palmieri and Company Incorporated ("VPCO"), as an investment manager of the Central States, Southeast and Southwest Areas Pension Fund (the "Fund"), will be acting in accordance with its fiduciary responsibilities under the Employee Retirement Income Security Act of 1974 ("ERISA") if it values the real estate-related assets held by the Fund for which VPCO is responsible for management, in the manner outlined within.

We understand that The Equitable Life Assurance Society of the United States ("Equitable") will shortly be submitting a request for an advisory opinion that is substantially similar to the request set forth herein.

This request is part of the series of ruling, advisory opinion and exemption requests that VPCO is submitting in connection with the new arrangements for independent management of the assets of the Fund. These arrangements, which are an integral part of the Labor Department's efforts to safeguard the Fund's assets for

Advisory Opinion
August 31, 1977
Page 2

the payment of pension benefits, are currently scheduled to go into effect on October 3, 1977.

Accordingly, we are prepared to meet with the Labor Department with respect to this request, and to cooperate and assist the Department to the fullest extent possible to expedite the resolution of this matter.

If there are any questions with respect to the enclosed request, please contact the undersigned (872-6784), Peter Schmidt (872-6834), or Lauralee Matthews (872-6791) of this firm.

Sincerely,

Paul S. Berger 
Attorney for Victor
Palmieri and Company
Incorporation

Enclosure

cc: Morton Klevan, Esq.
Alan D. Lebowitz, Esq.
Theodore R. Groom, Esq.

Request for Advisory Opinion
Submitted by
Victor Palmieri and Company Incorporated --
Valuation

It is respectfully requested that the Department of Labor issue an advisory opinion that Victor Palmieri and Company Incorporated ("VPCO"), as an investment manager of the Fund, will be acting in accordance with its fiduciary responsibilities under the Employee Retirement Income Security Act of 1974 ("ERISA") if it values the real estate-related assets held by the Fund in the following manner:

- (1) Nontroubled real estate mortgage loans will be valued at the remaining principal balance of the loan.
- (2) Troubled loans will be valued on the basis of the value of any real estate interest securing the loan, guarantees, and any other factors deemed relevant by VPCO.
- (3) Real estate owned by the Fund and real estate securing troubled loans will be valued at fair market value, using standard valuation

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techniques such as replacement cost, market data with respect to sales prices of similar properties, or capitalization of income generated or potentially generated, which will be supported, in some instances, by third-party appraisals of the property in question.

This request is submitted on behalf of VPCO pursuant to ERISA Procedure 76-1 (41 F.R. 36281, August 27, 1978). Set forth below is (1) a statement of facts relevant to this request, including a description of the Fund and VPCO, the background of this request, and the new arrangements for the management of the Fund's assets; (2) a statement of the advisory opinion requested; and (3) a discussion of the issues involved in this request.

STATEMENT OF FACTS

A. The Fund

The Central States, Southeast and Southwest Areas Pension Fund is an employee pension benefit plan established and maintained pursuant to collective bargaining agreements between employers and certain affiliated local

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unions of the International Brotherhood of Teamsters.^{1/} It was originally established in 1955 by trust agreement, amended from time to time thereafter, by and between the Central Conference of Teamsters, Central States Drivers Council, Southern Conference of Teamsters, and their affiliated local unions, and the Southeastern Area Motor Carriers Labor Relations Association; Southwest Operators Association; National Automobile Transporters Labor Council; Motor Carriers Employers Conference - Central States; Cartage Employers Management Associations; Cleveland Draymen Association, Inc.; and Northern Ohio Motor Truck Association.^{2/} In accordance with section 302(c)(5) of the Labor Management Relations Act, 1947 (29 U.S.C. 186(c)(5)), the Fund is jointly administered by ten trustees, consisting of an equal number of employee and employer representatives. Until now, the Trustees have had exclusive authority and responsibility for the management of the Fund's assets.

^{1/} The Fund's Employer I.D. No. is 36-6044243; its Fiduciary No. is 36-6514764.

^{2/} Central States, Southeast and Southwest Areas Pension Plan, Effective January 1, 1976, Art. 1, Sec. 2.

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More than 16,000 employers make contributions to the Fund pursuant to approximately 30,000 separate collective bargaining agreements involving over 300 local union organizations.^{3/} For the Fund's plan year ending January 31, 1976, the Fund received in excess of \$300 million in employer contributions. The number of active and retired participants of the Fund as of January 31, 1976, was estimated to be in excess of 450,000, and for the plan year ending on that date, the Fund paid benefits in excess of \$210 million.

The Fund generally covers Teamster employment in 33 states located, as the name of the Fund indicates, in the Central, Southeast and Southwest areas of the United States. As of January 31, 1976, the value of the net assets of the Fund was stated to be \$1,363,817,099, and the value of the mortgages held by the Fund equalled \$808,105,751.^{4/} The Fund is believed to be the second largest

^{3/} We understand that negotiations between the Teamsters and employer associations which result in the National Master Freight Agreement effectively establish or set the pattern for the applicable rate in most cases.

^{4/} The information in the noted and immediately preceding paragraph is extracted from the Annual Report (Form 5500)

[Footnote continued on following page]

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multiemployer plan in the United States today.

B. Background of this Request

The Fund has been the subject of investigation by the Department, the Justice Department, the IRS, the Securities and Exchange Commission and other government agencies for a period of years. It has also been the subject of numerous Congressional inquiries and hearings. In published statements of government agencies, Congressional Committees, and the Fund's staff, and in other publicly available information, there has been widespread criticism and allegation of civil and criminal abuse in connection with the management of the Fund's assets.

During the last year, the following governmental actions, among others, have been announced:

By letter dated June 25, 1976, the District Director of the Internal Revenue Service for Chicago revoked the Fund's tax exempt status.

[Footnote continued from preceding page] of the Fund for the plan year ending January 31, 1976, filed by the Plan Administrator with the Internal Revenue Service and the Department of Labor. The Fund's Annual Report for its plan year ending December 31, 1977 had not been filed as of the time this application was being prepared.

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Between the date of the initial revocation letter and March 14, 1977, the Service delayed the application of the revocation four times while government attorneys and attorneys for the Fund engaged in a series of negotiations on problem areas.^{5/}

On March 14, 1977, the Department and the Service issued a joint release (USDL 77-232, IR 1775) announcing the resolution of certain issues respecting asset management of the Fund "in a manner that meets the government's objectives." Among other matters, the release stated:

The trustees of the fund has resolved to delegate to one or more investment managers (as defined in section 3(38) of ERISA) the control of all investment of the Fund.

Based on this and other matters announced, and subject to the engagement of professional investment managers and other conditions, the Service stated that it would issue a determination letter requalifying the Fund, and the Department stated that it would terminate that portion of

^{5/} See IR-1637 (July 8, 1976); IR-1664 (August 30, 1976); IR-1699 (November 26, 1976); IR-1763 (February 25, 1977). See also Statement of Daniel Shannon, Executive Director, Central States Pension Fund, Before the House Ways and Means Oversight Committee (March 21, 1977).

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its investigation relating to procedures of the Fund respecting asset management.

Subsequently, on April 26, 1977, the Service issued a determination letter announcing the qualification of the Fund for tax years beginning after December 31, 1975. This determination letter was subject to a number of conditions which included the following:

8. The Trustees placing all Fund assets and receipts, including funds derived from liquidation of existing investments (except funds reasonably retained by the Fund for (a) payment of plan benefits and (b) payment of administrative expenses), under direct continuing control of independent professional investment managers as defined by Section 3(38) of ERISA. The Trustees will adopt appropriate amendments to the trust agreement to accomplish this condition and will expeditiously transfer the assets to the investment managers. Recognizing the complexities of the large investment portfolio, the completion date for accomplishing delivery of the investment assets will be no later than December 31, 1977. However, the securities-related assets and the majority of the real-estate related assets will be made available to the investment managers for inspection, documentation and evaluation no later than June 30, 1977.

During this same period of time, representatives of the Fund were actively discussing arrangements with

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potential investment managers, including VPCO, and on Friday, June 17, 1977, the Trustees of the Fund announced their decision to select VPCO as an investment manager for the Fund. The contractual arrangements, described in greater detail in following paragraphs, were executed by the Trustees on July 7, 1977, effective as of June 30, 1977.

The selection of independent investment managers for the Fund was clearly regarded by the government as a crucial objective of governmental demands upon representatives of the Fund. This fact was attested to in the statement of Secretary of Labor Marshall before a subcommittee of the Senate Committee on Government Operations on July 18, 1977, in which he indicated that the "primary goal had to be the preservation of the Fund assets," and in which he also stated:

In many ways, the second objective (that day-to-day asset management be taken out of the hands of the Fund's trustees) was the most important. It was imperative that those who contributed to the Fund should not see their assets dwindle because of mismanagement.

* * *

At a meeting on March 11, the trustees decided to comply with the Government's demand. On March 12, we met with their representatives. On March 14, the Labor

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Department and IRS issued identical news releases announcing the terms of an agreement. The critical points were as follows: (1) that the trustees would reach agreement in principle as soon as possible with one or more independent investment managers of nationally recognized stature; . . .

* * *

We believe that the contractual structure [between the Fund and VPCO and other independent managers] provides a sound basis for proper future management of the Central States Fund's giant portfolio. It removes entirely asset management control from the trustees, yet retains their authority and power to monitor performance. It provides sufficient security for the independent professional fiduciary and the investment managers to insure that they cannot be dismissed at the whim of the trustees, yet permits the trustees to dismiss them for cause. It leaves the affairs of a private sector fund in private sector hands, yet provides for lawfully authorized government assistance. It also contains a triggering device to insure government oversight in the event the trustees, Equitable or the investment managers need advice or help in matters relating to Fund management. And it contains great promise of ending, once and for all, the years of suspicion, allegations and demonstrable wrongdoing that have surrounded asset management of the Fund and the people associated with it. ^{6/}

^{6/} Statement of Secretary of Labor F. Ray Marshall, Hearings on Teamster Central States Pension Fund Task Force, Senate Permanent Subcommittee on Investigations, July 18, 1977.

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C. VPCO

Victor Palmieri and Company Incorporated ("VPCO") is a corporation which has provided executive management services to various businesses and whose application for registration as an investment adviser under the Investment Advisers Act of 1940 is currently pending. It is presently managing assets and operating companies valued at more than \$1,500,000,000, including all the nonrail assets and operating companies of the Penn Central Transportation Company and those of Levitt and Sons, Inc. It has a principal office at 2021 K Street, N.W., Washington, D.C. 20006; its Employer Identification Number is 95-2644662. Prior to its execution of the June 30, 1977 contracts, with one minor exception, it had no prior affiliation with the Fund.^{7/}

D. Equitable

The Equitable Life Assurance Society of the United

^{7/} The minor exception involves a loan made by the Fund in 1963 (and refinanced in 1974) to an independent third party to finance a hotel, secured by the hotel property and by guarantees of the third party. In 1976, a limited partnership, in which two executives (one also a stockholder) of VPCO have interests, purchased the hotel, subject to the Fund mortgage on which the third party remains liable.

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States ("Equitable") is a mutual life insurance company whose principal office is located at 1285 Avenue of the Americas, New York, New York 10019. Its Employer Identification Number is 13-5570651. Equitable is a New York corporation subject to the insurance laws of New York, and it is registered as an investment adviser under the Investment Advisers Act of 1940. Equitable is the third largest life insurance company in the United States; as of December 31, 1976, its assets equalled \$22,430,472,618. Prior to its execution of the June 30, 1977 contracts, with one minor exception, it had no affiliation with the Fund.^{8/}

E. The New Arrangements for the
Management of Fund Assets

In order to carry out the central part of their agreement with the Department and the Service of March 14, 1977, and the condition of the Fund's requalification letter of April 26, 1977 requiring independent investment managers for the assets of the Fund, the Trustees of the

^{8/} The minor exception involves a ground lease between the Fund and Equitable which arose because of a mortgage foreclosure between Equitable and an unrelated third party.

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Fund have entered into a series of agreements dated June 30, 1977 with Equitable, VPCO, Lazard Freres & Co. ("Lazard"), Mercantile National Bank at Dallas ("Mercantile"), and Crocker Investment Management Corp. ("CIMCO").^{9/} The agreements that are relevant to this request (attached as Exhibits A and B) establish the following arrangements for the management of the assets of the Fund.

The securities-related assets of the Fund (corporate stocks and debt securities, U.S. government securities, etc.) will be allocated for investment management initially to four investment managers: Equitable, Lazard, Mercantile, and CIMCO. Each investment manager will be allocated 25 percent of the total market value of the securities-related assets.

^{9/} In his statement before the Senate Permanent Subcommittee on Investigations on July 18, 1977, Secretary of Labor Ray Marshall stated that:

From the standpoint of the Government, the arrangement had to satisfy several criteria . . . The contractual structure had to be one which was workable and which met ERISA's requirements.

He further stated that, "The arrangements also had to involve managers who were competent and who could withstand public scrutiny," and that, "These institutions and their management assignments were fully satisfactory to the Labor Department."

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The real estate-related assets of the Fund (mortgages and properties), which comprise approximately 70 percent of the value of the assets of the Fund, will be allocated to Equitable and VPCO for investment management. Equitable will generally be responsible for the management of assets located east of the Mississippi River (approximately one-third of the total value of the real estate-related assets), and VPCO will manage the assets located west of the Mississippi River (the remaining two-thirds of the Fund's real estate-related assets).

Equitable will also assume the role of Fiduciary for the Fund, which will require Equitable to fulfill a number of functions in addition to serving as investment manager. Equitable will have exclusive authority and responsibility to monitor the performance of the other securities investment managers, to appoint and remove any or all of such managers, and to increase or decrease the portion of the securities-related assets allocated to such managers.

Equitable, together with the Trustees, will also be responsible for monitoring VPCO's real estate investment management performance. However, within the initial five-year

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period of these new arrangements, VPCO can only be removed (by the Trustees) for cause and with the approval of the Secretary of Labor.

Equitable's performance as Fiduciary and investment manager will be monitored by the Trustees. As in the case of VPCO, however, Equitable can be removed by the Trustees within the initial five-year period of the new arrangements only for cause and with the approval of the Secretary of Labor.

The administration of the Fund is within the sole authority and responsibility of the Fund Trustees, acting either directly or through the Executive Director of the Fund or the members of the Fund staff. The administration of the Fund includes, among other things, the establishment of benefit levels, the enforcement of collective bargaining agreements, the qualification, eligibility and payment of pension or other benefits, the actuarial soundness of the Fund, reporting responsibilities, and investment management of the Benefits and Administration Account.^{10/}

^{10/} The assets held in the Benefits and Administration Account are those which, in the determination of the Trustees, are needed by the Fund for payment of pension

[Footnote continued on following page]

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Under the June 30, 1977 agreements, each investment manager, including VPCO, is to value the assets assigned to it for management in accordance with procedures set forth in the agreements. The procedures concerning the valuation of a real estate-related asset are described more fully below.

VPCO, as investment manager for real estate-related assets of the Fund, is responsible solely for the day-to-day management of the assets which are allocated to it. VPCO will also be responsible for preparing a study evaluating the Fund's asset management staff. VPCO, however, has no authority or responsibility to monitor or oversee the activities of any other fiduciary of the Fund, any other investment manager, the Trustees, the Executive Director, or any Fund custodian.

[Footnote continued from preceding page] benefits, Fund administrative expenses, and an appropriate reserve therefor. The Benefits and Administration Account is managed by the Executive Director of the Fund under the supervision of the Trustees. Upon the request of the Executive Director of the Fund, Equitable is obligated to direct the transfer of monies to the Benefits and Administration Account. Neither Equitable nor any of the investment managers have any responsibility or authority with respect to any of the assets held in the Benefits and Administration Account.

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The new Fund investment management arrangements are scheduled to go into effect on the Closing Date of the agreements, with is now October 3, 1977.^{11/} This date can be extended by Equitable or VPCO if either determines that it has not received all necessary rulings, exemptions and opinions of governmental authorities. However, if the Closing Date does not occur on or before November 1, 1977, the Trustees of the Fund can elect to rescind the agreements. In this regard, VPCO believes that the receipt of a favorable response in reply to this request prior to the Closing Date is essential if VPCO is to assume its responsibilities for the Fund.

F. Provisions of the Agreements Relating to
Valuation of Real Estate-Related Assets

Pursuant to Article VI of the Master Agreement (Exhibit A) and Section 3.04 of the Investment Management Agreements for Real Estate-Related Assets (Exhibit B) each of the assets of the Fund for which VPCO is responsible for management, and which it does not recommend be valued

^{11/} Originally, the Closing Date was scheduled for September 1, 1977. On August 17, 1977, the Closing Date was postponed to October 3, 1977.

at book value is to be valued by VPCO.

The valuation of each real estate-related asset is to be completed within 12 months after that asset is initially accepted for management by VPCO. (Master Agreement Article VI, p. 14, Exhibit A). Prior to the initial acceptance of any real estate-related asset for management, VPCO will conduct a preliminary physical inspection of the asset and a preliminary examination of the documentation with respect to the asset.^{12/} As of the Closing Date, VPCO will accept those real estate-related assets scheduled for acceptance by it as to which inspection is complete and as to which VPCO is satisfied with the documentation reviewed as of the date.^{13/} Assets as to which inspection has not been completed or as to which the documentation reviewed by VPCO is not satisfactory as of the Closing

^{12/} This preliminary inspection and examination of documentation will not constitute the valuation contemplated by the contracts.

^{13/} Equitable may, in its discretion, elect not to accept any asset as to which it has completed preliminary documentation and inspection. Any asset which Equitable thus determines not to accept will be accepted by VPCO. (Master Agreement Section 5.05, Exhibit A; Investment Management Agreement for Real Estate-Related Assets, Section 3.02, Exhibit B).

Date will be accepted for management at such time after the Closing Date as inspection is completed and documentation is satisfactory to VPCO. (Master Agreement Article V, Exhibit A; Investment Management Agreement for Real Estate-Related Assets, Article III, Exhibit B).

Costs of the contracted work of architects, attorneys, accountants, appraisers, auditors, engineers, market and economic analysts and certain other experts retained by the investment managers in connection with the inspection, documentation, and valuation of assets will be paid by the Fund. However, the Fund will not reimburse Equitable and VPCO for the cost of appraisals used in the initial valuation in excess of a total of \$500,000 without express approval of the Trustees of the Fund. In addition, VPCO may not incur any single cost with respect to the audit or valuation of any asset where such cost is expected to exceed \$30,000 during the calendar year, without the express approval of Equitable; nor may Equitable incur any such cost without the express approval of its Board of Directors or a committee thereof. (Master Agreement Section 12.03, Exhibit A; Investment Management Agreement

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for Real Estate-Related Assets Sections 6.03-6.05, Exhibit B).

Section 6.02 of the Master Agreement (Exhibit A) sets forth the following procedures for the valuation of the real estate-related assets of the Fund:

6.02. Evaluation Procedures - Real Estate-Related Assets. With respect to each Real Estate-Related Asset which is accepted by it for management and which it does not recommend be valued at its book value, each investment manager shall promptly prepare a Valuation File containing such materials and documents as are ordinarily and customarily employed in the valuation of Real Estate-Related Assets including but not limited to, where deemed appropriate and necessary by the investment manager for such purpose, attorneys' opinions with respect to the validity and enforceability of the documentation evidencing, governing or pertaining to the asset; appraisals and all legal and collateral documents and summaries thereof; and a summary description of the asset, its history and all pertinent facts or circumstances relating to its value. Based on such materials and documents, such investment manager shall recommend in the Valuation File the value of each such Real Estate-Related Asset in accordance with applicable statutory requirements.

Each Valuation File and valuation recommendation shall be forwarded to the Trustees for agreement as to such value; if no such agreement as to value is reached,

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such Valuation File and valuation recommendation shall be forwarded to a Real Estate-Related Asset Valuation Committee (the "Real Estate Valuation Committee") composed of three disinterested persons experienced in the evaluation of Real Estate-Related Assets, who shall be paid a reasonable fee by the Fund. All three members of the Real Estate Valuation Committee shall be selected by the U.S. Department of Labor from a list of nominees submitted for that purpose by Equitable and VPCO.

The Real Estate Valuation Committee shall examine such Valuation File and valuation recommendation, together with such further information as may be available to or required by such Real Estate Valuation Committee, and shall establish by majority vote a value for each such Real Estate-Related Asset as of the Valuation Date, which value shall be conclusive and binding for all purposes of this Agreement upon the Fund and all other parties hereto, as the value of each such asset as of Valuation Date.

The same valuation procedure is set forth in Section 3.04 of the Investment Management Agreement between the Trustees, Equitable, and VPCO, attached as Exhibit B.

There are a number of other provisions of the agreements which may be related in some way to the valuation procedures. These include provisions relating to the coordination of investment policies and actuarial requirements

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(Master Agreement Section 1.06, Exhibit A) and to periodic reporting requirements (Master Agreement Section 1.07), provisions setting forth certain recordkeeping requirements (Master Agreement Section 1.08) and provisions defining basic services as including the preparation of valuation files (Exhibit B, Section 4.01(f)), periodic valuations of loans, supervising management information systems and determining the need for loss reserves under statutory requirements (Exhibit B, Sections 4.01(f), 4.02(e), (j), and (m)).

ADVISORY OPINION REQUESTED

Based on the facts and representations set forth in this submission, it is requested that the Department issue an advisory opinion that VPCO will be acting in accordance with its fiduciary responsibilities under ERISA if it values the real estate-related assets held by the Fund in the following manner:

- (1) Nontroubled real estate mortgage loans will be valued at the remaining principal balance of the loan.

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- (2) Troubled loans will be valued on the basis of the value of any real estate interest securing the loan, guarantees, and any other factor deemed relevant by VPCO.
- (3) Real estate owned by the Fund and real estate securing troubled loans will be valued at fair market value, using standard valuation techniques, such as replacement cost, market data with respect to sales prices of comparable properties, or capitalization of income generated or potentially generated, which will be supported in some instances by third-party appraisals of the property in question.

NEED FOR THE REQUESTED ADVISORY OPINION

VPCO will be a fiduciary with respect to the Fund within the meaning of section 3(21) of ERISA by reason of its investment management responsibilities. Together with the other new independent investment managers, VPCO has been retained by the Fund for essentially one purpose -- to remove responsibility for the investment of Fund assets from the Trustees and to turn such responsibility over

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to independent professional investment managers of long experience and high integrity. As noted above, this purpose was a "primary goal" of the Labor Department in connection with its investigation of the Fund.

One of the functions assigned to each investment manager is the valuation of such assets of the Fund as the respective investment manager does not recommend be valued at book value. This valuation is to be completed within 12 months after acceptance of such assets in accordance with the terms of the agreements.

We note that the value of the assets of the Fund, particularly the real estate-related assets, has recently been the subject of some concern and public controversy. At hearings on the Central States Pension Fund conducted by the Senate Permanent Subcommittee on Investigations on July 18, 1977, Senator Charles Percy stated that:

There is concern on the part of some federal officials that the Fund may have lost between \$500 million and \$700 million -- perhaps as much as one-half of the Fund's assets -- because of these bad investments.

During questioning at these hearings, it has been reported that Labor Department officials indicated that the value

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of the Fund's assets was not known.^{14/} As a result, Senator Percy further stated in his closing remarks that:

I am deeply troubled, however, by the total lack of information on the part of the Labor Department and the Internal Revenue Service concerning the value of [Fund] assets and the number of loans still outstanding.

It has been reported that spokesmen for the Fund have labeled Senator Percy's charges as "preposterous" and have stated that these charges can be rebutted.^{15/}

VPCO believes that it is important that Fund assets not be overvalued. (E.g., financially troubled loans should not be carried at book value.) It believes, however, that valuing the nontroubled assets of an ongoing plan on a liquidation basis could be greatly misleading to participants and employers and could precipitate contribution delinquencies, withdrawals and other acts that would have a material and adverse effect on the rights of participants and beneficiaries.

In this regard, Section 6.02 of the Master Agreement,

^{14/} New York Times, July 19, 1977, p. 16.

^{15/} Pensions and Investments, August 1, 1977, p. 1.

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quoted above, requires that VPCO make recommendations for valuing each real estate-related asset for which it is to be responsible and "which it does not recommend be valued at its book value . . . in accordance with applicable statutory requirements." The "applicable statutory requirement" in ERISA is the requirement of section 404, under which VPCO, as a fiduciary with respect to the Fund, must fulfill its valuation obligation prudently and in accordance with the interests of Fund participants and beneficiaries.

The responsibility to insure compliance with the reporting and funding requirements of ERISA is not a responsibility of VPCO, and the agreements do not specify use of the investment managers' valuations with respect to the plan administrator's fulfillment of such responsibility. Nonetheless, it is quite possible that the Trustees, as the plan administrator for the Fund, may determine that the valuations prepared by the investment managers are appropriate for such purposes. In this connection, it might be said that it would be prudent for the valuations produced by VPCO, where otherwise appropriate,

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to be useful to the Trustees in meeting their reporting and funding responsibilities, particularly where producing such valuations involves substantial expenditures of plan assets. For this reason, it is helpful to review the reporting and funding requirements of the Act.

ERISA ANNUAL REPORT AND FUND-
ING VALUATION PROVISIONS

1. Form 5500

As a part of the annual report filed pursuant to section 103 of ERISA^{16/} the plan administrator of most plans, including the Fund, is required to include a number of schedules which reflect the value of plan assets

16/ Section 103(a)(1)(A) of ERISA provides that:

An annual report shall be published with respect to every employee benefit plan to which this part applies. Such report shall be filed with the Secretary in accordance with section 104(a) and shall be made available and furnished to participants in accordance with section 104(b).

Form 5500 has been adopted by the Labor Department as the appropriate form for the preparation of the annual report required pursuant to section 104(a)(1)(A).

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at "current value."^{17/} The term "current value" is defined in section 3(26) as follows:

[F]air market value where available and otherwise the fair value as determined in good faith by a trustee or named fiduciary (as defined in section 402(a)(2)) pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination.

No regulations have as yet been issued by the Department with respect to determining "current value" pursuant to section 3(26). In addition, the instructions to Form 5500 repeat the statutory definition of "current value" without clarification. Thus, there is no published guidance by the Department as to what constitutes the proper method, for purposes of the annual report, of determining "current value" for real estate mortgage loans and other real estate-related assets which do not commonly have a fair market value.

^{17/} These schedules include a statement of assets and liabilities (section 103(b)(3)(A)), a schedule of assets held for investment purposes (section 103(b)(3)(C)), a schedule of party in interest transactions (section 103(b)(3)(D)), and a schedule of reportable transactions (section 103(b)(3)(H)). See also items 13 and 24(b)(i), (ii), and (iii) of Form 5500.

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2. The Funding Requirements

The Fund is a collectively bargained multi-employer defined benefit pension plan and, as such, will become subject to the minimum funding requirements of Part 3 of Title I of ERISA (and section 412 of the Code) within the next several years pursuant to section 306(c)(1) of ERISA. Plans subject to Part 3 are generally required to establish a funding standard account to determine their minimum funding requirements. In making these computations, section 302(c)(2)(A) provides that:

For purposes of this part, the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary of the Treasury.

However, section 302(c)(2)(B) provides that:

For purposes of this part, the value of a bond or other evidence of indebtedness which is not in default as to principal or interest may, at the election of the plan administrator, be determined on an amortized basis running from initial cost at purchase to par value of maturity or earliest call date. Any election under this subparagraph shall be made at such time and in such manner as

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the Secretary of the Treasury shall by regulations provide, shall apply to all such evidences of indebtedness, and may be revoked only with the consent of the Secretary of the Treasury.

Thus, it appears that, with respect to evidences of indebtedness, such as real estate mortgage loans which are not in default, the remaining principal balance of a loan would be deemed to be the equivalent of "fair market value" for funding purposes for any plan electing to comply with section 302(c)(2)(B). In this regard, the Committee Reports accompanying bills that were predecessors of ERISA, but which contained essentially the same provisions as section 302(c)(2) quoted above, stated the following:

In general, for purposes of funding, the value of the plan's assets is to be determined on the basis of any reasonable actuarial method of valuation which takes fair market value into account under regulations prescribed by the Secretary of the Treasury or his delegate. However, to permit fixed obligations, which frequently are held until maturity to be given stable values for funding purposes the plan administrator is given the option of determining the value of the bond or other evidence of indebtedness (which is not in default as to principal or interest) on an amortized basis.

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Your committee also recognizes that often a pension plan will acquire bonds or other debt instruments as a long-term investment to be held until maturity. In that event, it would seem inappropriate to require the plan to change its valuation of the bond in accordance with market fluctuations. Therefore, the bill provides that a plan may elect to value its bonds or evidence of indebtedness on an amortized basis. At the election of the plan, the amortization may run from initial cost at purchase to par value at earliest call date or to par value at maturity. This election is to be made at the time and in the manner prescribed by regulations. The election is to be revocable only with the consent of the Internal Revenue Service and is to apply to all bonds and evidences of indebtedness owned by the plan. Although the bill explicitly recognizes this as one reasonable method of valuation that a plan may use to value bonds or evidences of indebtedness, other valuation methods may be used for these assets. (Also, it may be reasonable to use the method explicitly recognized for valuing other assets.) H.R. Rep. No. 93-779, 93d Cong., 2d Sess. 26, 95-96 (1974). See also, H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 27, 96-97 (1974).

DISCUSSION OF VALUATION PROCEDURE

Nontroubled Loans

The valuation procedure which is the subject of this request would permit VPCO to value nontroubled real

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estate mortgage loans held by the Fund at the remaining principal balance of each such loan. VPCO believes that this is the proper method of valuation in this case because (a) this is the method customarily used in the valuation of real estate mortgage loans; (b) values derived in this manner have been relied on consistently by all of the Fund's independent actuaries; and (c) it is a proper method for valuing mortgage loans in an ongoing portfolio.

- (a) The remaining principal balance valuation method is customarily used in the valuation of nontroubled real estate mortgage loans.

The remaining principal balance valuation procedure described above is not a procedure that VPCO has developed solely for purposes of valuing the assets of the Fund. Rather, this is a procedure that is customarily used in the valuation of nontroubled mortgage loans by other institutional investment managers.

Real estate mortgage loans have long been one of the two principal categories of long-term investments by U.S. life insurance companies. At the end of 1976, U.S. life insurance companies had over \$91.6 billion and 28.5%

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of their total assets invested in mortgage loans. On the same date, Equitable had nearly \$8 billion invested in mortgage loans.

The procedure described herein is the same as that used by Equitable and other life insurance companies with respect to nontroubled loans in their real estate-related portfolios. Equitable and other life insurance companies also use the remaining principal balance valuation method in valuing real estate mortgage loans for purposes of determining their solvency under state insurance laws.

Under federal income tax laws pertaining to life insurance companies, the valuation of assets is a significant factor in determining the tax liability of the company. For this purpose,^{18/} stock and properties are valued at fair market value, but real estate mortgage loans and other fixed income assets are valued at their adjusted basis, which is essentially the equivalent of the remaining principal balance valuation method.

Accordingly, the "remaining principal balance" valuation method is the common method for valuing nontroubled

^{18/} Section 803(b)(4) of the Internal Revenue Code of 1954.

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loans in active real estate portfolios, particularly where the intention is to hold such loans until maturity, which apparently will be the case with respect to many of the nontroubled loans currently held by the Fund.

- (b) The remaining principal balance method has led to a value for mortgage loans that has been consistently relied on by all of the Fund's independent actuaries.

Three actuarial reports have recently been prepared for the Fund by three separate independent actuarial firms.^{19/} In each case, the actuaries relied on the statement of net assets set forth in the Fund's Form 5500, which, with respect to the mortgage loans held by the Fund, appear to have been valued on the basis of the remaining principal balance of each loan (except in the case of troubled loans marked down in value.) We have not yet had an opportunity to determine whether this procedure was followed consistently by the Fund in the past. However, we note that each of the actuarial reports characterizes the value set forth in Form 5500 as "current value" or "market value."

^{19/} Dan McGinn & Associates, Inc. (January 11, 1976); American Actuarial Pension Consultants, Inc. (December 15, 1976) and the Wyatt Company (January 17, 1977).

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- (c) The remaining principal balance method is a proper method for valuing nontroubled mortgage loans in the circumstances of this case.

Using any method other than the remaining principal balance method for valuing nontroubled loans in the substantial mortgage loan portfolio of an ongoing plan may distort the true value of the plan's assets.

It could be argued that, in order to determine the "current value" of any real estate mortgage loan, one must value on the basis of current yield which, in turn, is based on the loan's interest rate in comparison to current interest rates. In that case, if the interest rate on the loan in question were lower than the current interest rate generally available, the value of the loan would be reduced. Conversely, if the interest rate on the loan in question were higher than the then-prevailing interest rate, the value of the loan would be increased. In the case of the Fund, which has a large number of loans entered into in periods when interest rates were substantially lower than they are today, a current-yield type of valuation would result in a large reduction in the value of the Fund's assets. However, such a decreased value

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would not properly reflect the value of such assets where, as is apparently the case here, many of the loans will be held to maturity. Rather, this reduced value would reflect the amount that would hypothetically be realized by the Fund if it attempted to sell each loan to a third party.

In a prior submission relating to the diversification of Fund assets (transmitted by letter dated August 1, 1977), we explained that it was not the current intention of VPCO to liquidate the real estate mortgage loan portfolio of the Fund, but rather that there was a substantial probability that many untroubled loans would be held until maturity. One of the reasons for this probability is that the secondary market in large nonresidential and nonguaranteed real estate mortgage loans is weak. Depending upon a number of factors such as the current money supply, any attempt to liquidate a large mortgage loan portfolio of this type could result in substantial discounts, and sales and reinvestment costs that would produce a lower overall investment return than if such loans were held to maturity.

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There is no assurance that over time interest rates will invariably rise, and, in fact, interest rates do fall as well as rise. If the intention is to hold loans until maturity, the true status of the loan portfolio is distorted if values of assets are decreased and increased with every fluctuation in interest rates when the amount that will ultimately be realized is in fact fixed, i.e., the principal amount of the loan. This is a very different situation from investments without a fixed overall return, e.g., common stocks, which to a much greater extent are held for eventual sale and whose future value is not known.

Consequently, it would be misleading with respect to the nontroubled loans in the Fund's portfolio to report value based on a "market" that does not exist and that does not reflect the expectations of the investment managers with respect to the amount that will ultimately be realized from the investment.

Finally, we note that placing market values on the nontroubled loans in the Fund's portfolio would involve an additional administrative burden for the Fund. Current

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market rates vary with local conditions, and the process of making "market" adjustments to a large national portfolio of loans would be complex and costly. We see no reason for the Fund to bear this burden in order to place values which, in our view, do not serve a useful or necessary purpose. In this connection it should be noted again that the contracts contemplate an independent valuation by the managers only for such assets "which [the manager] does not recommend be valued at [their] book value."^{20/}

Troubled Loans and Owned Real Estate

The method set forth in this submission contemplates valuing owned real estate and the real property securing troubled loans at fair market value, using standard valuation techniques as set forth in numerous texts on the subject. See, e.g., S. Maisel & S. Roulac, Real Estate Investment and Finance (1976) at p. 306 et seq. Market comparison, replacement cost, and income capitalization are the methods customarily used in valuing real

^{20/} Master Agreement Section 6.02. Investment Management Agreements for Real Estate-Related Assets, Section 3.04.

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estate. In the case of troubled loans, while the value of the underlying real estate security will nearly always be relevant in determining the value of the loan, personal guarantees, the potential for modifying the loan to "work out" the transaction and other factors may also be relevant. VPCO has considerable experience and expertise in valuing real estate assets and troubled loans secured by such assets, and these are the factors it has looked to in making such valuations.

CONCLUSION

Accordingly, based on the facts and representations set forth above, it is hereby requested that the Department of Labor issue an advisory opinion that VPCO will be acting in accordance with the fiduciary responsibilities to the Fund under ERISA if it values the real estate assets held by the Fund in the following manner:

- (1) Nontroubled real estate mortgage loans will be valued at the remaining principal balance of the loan.
- (2) Troubled loans will be valued on the basis of the value of any real estate interest

securing the loan, guarantees, and any other factors deemed relevant by VPCO.

- (3) Real estate owned by the Fund and real estate securing troubled loans will be value at fair market value, using standard valuation techniques such as replacement cost, market data with respect to sales prices of similar properties, or capitalization of income generated or potentially generated, which will be supported, in some instances, by third-party appraisals of the property in question.

If it is contemplated that the Department will not issue the requested advisory opinion, a conference is hereby requested. If any further information is required in connection with this request, please contact Paul S. Berger (872-6784), Peter Schmidt (872-6834), or Lauralee Matthews (872-6791) of this firm.

Respectfully submitted,

Paul S Berger
Attorney for Victor Palmieri
and Company Incorporated

Enclosures - Exhibits A, B -- Agreements dated June 30, 1977
Response of the Director,
Office of Regulatory Standards
and Exceptions

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Based on the facts and representations stated in the foregoing and the exhibits attached thereto, and more particularly the facts and representations contained on pages 16 through 39 of your letter, and without necessarily agreeing with the legal analysis set forth therein, it is the opinion of the Department of Labor that Victor Palmieri and Company Incorporated (VPCO), as an investment manager for the real estate-related assets of the Central States, Southeast and Southwest Areas Pension Fund (the Fund), will be acting in accordance with its fiduciary responsibilities to the Fund under the Employee Retirement Income Security Act of 1974 (ERISA), if it values the real estate-related assets held by the Fund as follows:

(1) nontroubled real estate mortgage loans at the remaining principal balance;

(2) troubled loans on the basis of the value of any real estate interest securing the loan, guarantees and other factors that a prudent person valuing the loan would deem relevant; and

(3) real estate and real property securing troubled loans at fair market value utilizing standard real estate valuation techniques.

Of course, any valuation method used must be appropriate to the particular facts and circumstances relating to the asset being valued. For example, a nontroubled

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real estate loan which the asset manager knows is to be sold at a discount in the near future should be valued to reflect the discount at which the asset manager expects the asset will be sold. Similarly, while market comparison, replacement cost, and income capitalization are methods customarily used in valuing real estate, the weight to be given to any particular valuation method in a specific situation would be dependent on the applicability of the method to that situation.

The Department is not hereby ruling as to what constitutes a "troubled loan." That decision is one which VPCO must make, based on all the relevant factors. Further, in making this determination, the Department is not hereby ruling with respect to whether the plan administrator of the Fund may utilize such valuations for the purpose of reporting the "current value" of real estate-related assets on Form 5500. The "current value" of Fund assets must be independently determined by the plan administrator in accordance with the provisions of sections 3(26) and 103 of ERISA, Form 5500, and any applicable regulations. Moreover, the Department is not hereby making any determination with respect to the utilization of such valuations by the Fund's administrator for purposes of determining whether the Fund has met the minimum funding standards contained in section 302 of ERISA.

Fred W. Stuckwisch
Director, Office of Regulatory
Standards and Exceptions