8-28-1985

Appellants' Reply Brief

Lewis M. Steel '63

85-7206

To be Argued by:
LEWIS M. STEEL

United States Court of Appeals

for the

Second Circuit

F.H. KREAR & CO., A Corporation,

Plaintiff-Appellee,

— against —

NINETEEN NAMED TRUSTEES, AS TRUSTEES OF LOCAL 69 PENSION FUND, LOCAL 69 VACATION FUND & LOCAL 69 HEALTH BENEFIT FUND; JOHN H. LEAVER, FRANK ESPOSITO, ANTHONY NICOLETTI, AL EHRLICH, CAROL MURRAY, ROYLAND H. HILL, JAMES SANTOS, EDWARD SEAMAN, STEVE WILSON, VICTOR MAYERS, GERSON KAISERMAN, JOSEPH YACHNOWITZ, RICHARD SYLVAN, NORMAN SHAPIRO, FRED H. McKENNA, ANGELO DADOLATO, ROBERT E. DOWD, EDWARD J. EGAN and BERT LEVENTHAL,

Defendants, Third Party Plaintiffs, Fourth Party Plaintiffs-Appellants,

HOTEL & RESTAURANT EMPLOYEES & BARTENDERS INTERNATIONAL UNION PENSION FUND and HOTEL & RESTAURANT EMPLOYEES & BARTENDERS INTERNATIONAL UNION WELFARE FUND BY THEIR TRUSTEES, EDWARD T. HANLEY, JOSEPH BELARDI, JOHN C. KENNEALLY, HERMAN LEAVITT, PAUL McCASTLAND, RONALD RICHARDSON, WILLIAM SCHUMAN, JOHN CULLERTON, LEWIS R. COHEN, DONALD S. DEPORTER, DOMINIC LUONGO, A.W. MITCHELL, BEN SCHMONTEY, HERBERT TRIPLETT, A.M. CHARLES, PATRICK KANE, FREDRIC N. RICHMAN, VITO PITTA,

Defendants, Counterclaim Plaintiffs-Appellants,

— against —

ANTHONY GRAUSO, Individually and
d/b/a SOFTWARE & SYSTEMS DEVELOPMENT CO., A PARTNERSHIP,

Third Party Defendants-Appellees,

ROBERT MOZER,

Third Party Defendant, Fourth Party Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANTS' REPLY BRIEF

(For appearances see reverse side of cover)

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PRELIMINARY STATEMENT

This reply Brief responds only to the arguments in F. H. Krear's Brief (which are echoed in the Grauso Brief) relating to the trustees' right to call an expert witness on the issues of the excessive F. H. Krear charges and non-performance. Appellants are responding because these issues, especially as they are formulated in the F. H. Krear Brief, raise important questions concerning the reach of the Employee Retirement Income Security Act of 1974 ("ERISA").

Appellants further note that F. H. Krear's factual presentation to this Court is based upon a view of the case devoid of expert testimony. Thus, appellee Krear tells this Court its case was based upon "overwhelming evidence" (Brief at 19), a statement which not only ignores the substantial testimony presented by the trustees on the issue of F. H. Krear's day to day non-performance, but importantly ignores the fact that the defense was incapable of analyzing performance from a technical point of view without the aid of an expert witness.

Finally, appellees note that F. H. Krear's Statement of Facts creates a picture-book version of a struggle between decent local union leaders and their advisors, including Mozer and Grauso, on the one side and scheming union leaders on the other side. This version

of the events, based upon self-serving testimony, cynically ignores the fact that the trustees' expert witness would have shattered this image with his testimony that F. H. Krear was charging between two and three times the industry-wide rates for its work. The jury apparently accepted F. H. Krear's version of what occurred, but it did so because it had not heard a professional critique as to how F. H. Krear was actually performing and was unaware of the extent that it was overcharging the funds.

ARGUMENT

I.

F. H. KREAR'S CONTENTION THAT ERISA DOES NOT PROHIBIT IT FROM CHARGING EXCESSIVE FEES IS ERRONEOUS, AND THE COURT'S FAILURE TO ALLOW THE JURY TO CONSIDER EXPERT TESTIMONY ON THIS ISSUE REQUIRES REVERSAL.

F. H. Krear's assertion (Brief, Point IV) that it was not required by ERISA to charge the funds no more than reasonable rates, and therefore the trustees' excessive costs defense was improper, is central to its assertion that the court below properly refused to allow the defense to call Hugh Brookhart, its expert witness who was concededly qualified to testify on this issue (A1393). If the trustees were entitled to prove that the contracts required excessive payments to F. H. Krear in violation of ERISA, obviously they should have been allowed to present expert testimony to prove that defense by establishing the usual rates in the industry. Contradictorily, the court below ruled that the defense was properly before the jury (A2307) but prohibited the expert testimony.

The district court certainly was correct that the defense was proper. F. H. Krear does not dispute that it became a fiduciary on July 1, 1979 when it took over the administration of the funds. The corporation's vice president, Saul Weiner, admitted the company's fiduciary status and stated he understood this created the

obligation "to conserve fund assets" (A768). He also admitted that after July 1st, Krear was ultimately responsible for the administration of the funds (A672-3; see also A2569).

Contrary to the contention in F. H. Krear's Brief (at 40) that the corporation was not a "party in interest" under ERISA, F. H. Krear by definition had this status as of July 1, 1979. The term "party in interest" is statutorily defined, and includes "any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian) counsel, or employee of such employee benefit plan." 29 U.S.C. §1002(14)(A). The definition section also states that a person providing services to such plan is a party in interest. 29 U.S.C. §1002(14)(B). Thus, contrary to F. H. Krear's contention, the corporation was subject to the prohibited transaction rules of 29 U.S.C. 1106 and therefore had to function within the exception contained in 29 U.S.C. §1108(b), which allowed it to charge "no more than reasonable compensation" for its services. 29 U.S.C. 1108(b)(2).

Under 29 U.S.C. §1104, fiduciaries are also prohibited from paying out more than reasonable expenses for administering an ERISA regulated plan. Clearly

therefore, F. H. Krear's claim that ERISA did not prohibit it from charging more than reasonable fees should be rejected.

As Senator Harrison Williams, Jr., the Chairman of the Senate Committee on Labor and Public Welfare, stated upon introducing the conference report on ERISA to the Senate:

> [ERISA imposes] strict fiduciary obligations upon those who exercise management or control over the assets or administration of an employee pension or welfare plan. 120 Cong. Rec. 29929(1974)

The legislative history also makes clear that:

> ...a party in interest may furnish goods, services, and facilities to a trust if this is necessary for the operation of the plan and the compensation paid is not excessive. (Emphasis added) S.Rep. 93-383, 93d Cong., 2nd Sess., reprinted in 1974 U.S.Code Cong. & Ad. News 4890, 4892

Fiduciaries such as F. H. Krear are subject to a full range of legal remedies for breaches of their duties under 29 U.S.C. §1109. Moreover, under 29 U.S.C. §1132 the trustees of the funds, as fiduciaries, are specifically authorized to bring suits against another fiduciary for breach of its obligations.

This Circuit has clearly held that the remedial sections of ERISA are intended to provide the full range of legal and equitable relief which includes the restoration of losses caused by a breach of fiduciary duty.

Marshall v. Snyder, 572 F.2d 894, 901 (2d Cir. 1978). It is also established law that once trustees become aware of the fact that they have entered into an imprudent or excessive contractual relationship, they are duty bound to disengage themselves from that relationship. Morrissey v. Curran, 567 F.2d 546 (2d Cir. 1977); Buccino v. Continental Assurance Co., 578 F.Supp. 1518 (S.D.N.Y 1983); Weisler v. Metal Polishers Union, 533 F.Supp.209, 215-216 (S.D.N.Y 1982). As the court said in Donovan v. Mazzola, 716 F.2d 1226, 1231 (9th Cir.1983), cert. den. 104.S Ct.704 (1984), "...in enacting ERISA Congress made more exacting the requirements of the common law of trusts." See also Sinai Hospital of Baltimore v. National Benefit Fund for Hospital & Health Care Employees, 697 F.2d 562, 565 (4th Cir. 1982).

Nor may F. H. Krear contend that it is not bound by ERISA's reasonable charges requirements merely because it was not a fiduciary at the time it negotiated its contracts. The parties to a contract are presumed to have in mind any existing law which relates to the subject matter of their contract and such a law becomes as much a part of the contract as if it were written directly into the contract between the parties. Dolman v. United States Trust Co., 2 N.Y. 2d, 110, 116 (1956); Kasen v. Morrell, 6 A.D.2d 816, 817 (2nd Dep't 1958); Skandia America Reinsurance Corp. v. Schenck, 441 F.Supp. 715,

724 (S.D.N.Y 1977). Even a contract negotiated at arms length and between equal parties is void and unenforceable if it violates public policy as it is expressed in a law passed by Congress. United States v. Richmond, 550 F.Supp.605, 609, (E.D.N.Y 1982); 21 N.Y.Jur. 2d, Contracts 144.

F. H. Krear relies only on one case, Schulist v. Blue Cross of Iowa, 717 F.2d 1127 (7th Cir. 1983) for the proposition that it should not be considered a fiduciary here. That case involved the rates that Blue Cross was charging a fund. The court, however, pointed out that Blue Cross did not exercise discretionary authority with respect to the setting of rates. Here, of course, F. H. Krear could have bargained for an appropriate rate, rather than an excessive rate. But it made no effort to do this. To the contrary, at the time that John David Krear was telling the trustees that his proposal would be cost effective (A2847-50), he did not even know "what employer-employee benefit funds, such as the funds involved here, paid in administrative costs." (A2861). Instead, he referred the trustees to insurance rates in other industries because, "it's always good to set up a straw man and then knock him down" (A2862). In fact, in the only internal budget which Krear prepared (A2802-3; See Exhibit H, A2438) he estimated that the corporation was going to make extraordinary profits out of the

$50,000 a month guaranteed income it was to receive. That budget reveals that Krear estimated that 16.72% of revenues would be left over after all expenses and salaries were paid and after allocating $6,000 per month for consulting and sales commissions (to unidentified persons), $3,240 per month for a contingency fund and $3,000 per month in Westchester and $7,000 per month in Washington, D.C. for "client entertainment and new business acquisition efforts only" (A2438, fn.3). Certainly, therefore, the Schulist rationale does not apply to this case.

Even if Schulist did speak to the issue before this Court, its narrow view of the reach of ERISA has not been adopted in this Circuit. The Seventh Circuit's restrictive approach is contrary to the broad view of the remedial reach of ERISA taken by this Court in Morrissey v. Curran, supra. Morrissey dealt with the issue as to whether trustees could continue holding for their funds unwise investments obtained before the passage of ERISA. The Court ruled they could not, but instead were bound to liquidate such holdings. By analogy, once F. H. Krear became a fiduciary of the funds, it simply could not charge them unreasonable amounts for its services merely because it negotiated the contracts before it was technically a fiduciary. See also 65 Security Plan v. Blue Cross and Blue Shield, 588 F.Supp. 119 (S.D.N.Y.

1984) wherein a district judge in this Circuit has explicitly rejected the rationale of Schulist on the ground that it takes a very restrictive view of ERISA and in that respect does not carry out the congressional intent. See also the district court's analysis in its earlier Blue Cross and Blue Shield decision, 583 F.Supp.380 (S.D.N.Y. 1984), which is supportive of appellants' view of the law.

F. H. Krear's other arguments in support of its claim that the court below did not abuse its discretion in denying the trustees the right to call an expert witness on the issue of excessive costs are equally specious. First, the F. H. Krear Brief states that the fund's attorney, Robert Mozer, testified that "no professional administrator involved with union funds (such as Brookhart) was, in fact, willing to work for the funds and thereby run afoul of the international union" (Brief at 23). According to this argument, the funds had no choice but to go with F. H. Krear. In actuality, Mozer testified that a few of the persons he contacted indicated that their companies did not do the type of work in question, that a few did not want to get involved because of the union situation, and that one third-party administrator, ACI, was interested in the work (A362-5). Moreover, F. H. Krear subcontracted out virtually all of the computerization work to American Management Services,

Inc. (AMS), a company that Mozer was familiar with at the time he was talking to Krear and Weiner (A437-8). Finally, Mozer knew F. H. Krear was going to subcontract out the work (A2858), and therefore knew that a company could readily be found to do the work.[1]

Certainly, therefore Brookhart should have been allowed to testify that other third-party administrators were available to do the work and to testify with regard to the prevailing rates in the industry at the time (A1387). Perhaps F. H. Krear was entitled to argue to the jury that no administrator would have done the work, but the jury was entitled to know, as the court below itself stated, "that there was a certain fee charged in the industry..." (A1389).

F. H. Krear also argues that the jury had before it enough evidence to determine what the rate in the industry was, without expert testimony. (Brief at 24-5). This argument, however, is without substance. The fund's accountant, Harold Silverberg, was allowed to testify that Krear was actually charging the welfare fund 21.5% of contributions plus rent and other charges (A874), but was not allowed to compare that figure to the time period before Krear took over (A875). Nor, of course, could

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[1]ACI provided insurance and pension plan administration for many different funds, plans, and unions, including the Archdiocese of New York (A2482-4), and AMS did work for one of Mozer's clients, the National Council of Senior Citizens (A2653,349).

Silverberg testify about the customary rate in the industry as this was not his area of expertise. Nor did the testimony of Michael Gantert, who worked for the third-party administrator who obtained the contracts after Krear, give the jury sufficient testimony on costs. Gantert did testify that the welfare fund was charged 8.3% of contributions initially, a figure which was reduced to 6.5% in November of 1980 (A992,1130-1). But Gantert only testified as to what his company charged, not what the industry-wide rates were. His company was also attacked as being part of the "henchmen" conspiracy and Gantert was challenged with regard to the accuracy of his figures. See F. H. Krear Brief at 18.

Trustee John Dowd's testimony that after entering into the contracts he had heard that the industry-wide rate was between 5 to 7 percent also did not establish what these rates actually were. Finally, trustee Leaver gave testimony as to how much ACI had been charging the union and vacation fund prior to July 1, 1979. But Leaver gave no testimony as to how those amounts translated into percentages of contributions (A1723-9) nor was he able to testify with regard to how ACI's past workload would have compared to the functions of the new service provider which was to handle the welfare and pension funds for whom ACI did not work.

Only Brookhart could have given the jury the information necessary for it to determine whether F. H. Krear's charges were reasonable under ERISA. By denying the trustees the ability to present such testimony, the court below effectively took this issue away from the jury.

II.

THE ASSERTION THAT THE TRUSTEES' EXPERT DID NOT HAVE A PROPER FACTUAL BASIS TO RENDER AN OPINION ON PERFORMANCE ISSUES IS GROUNDLESS

F. H. Krear argues that Brookhart was given documents and deposition testimony which related only to an interim system being designed by AMS, rather than the final system which the corporation was going to design and therefore his testimony would have been irrelevant (Brief at 26). Yet John David Krear admitted that AMS had been hired to develop the "finished system" which his corporation was required to produce (A285-67), and the AMS project manager testified that his company was working on the final system, not an interim system (A2732). Thus, Brookhart clearly was in a position to analyze AMS reports to F. H. Krear (See, e.g., Exhibits HHH, KKK, A2543-55), the AMS deposition testimony (some of which was introduced in evidence at trial) and the Grauso reports which were also trial exhibits, in order to give testimony as to whether F. H. Krear and/or its subcontractor was meeting the time tables in its proposal (A2361-3) which F. H. Krear itself stated should be considered as a part of the contracts (Brief at 27, fn.9).[2]

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[2]For example, by the middle of September, according to the time table, the preliminary task analysis should have at least been accomplished and reviewed. This should have been accomplished by the 11th week, counting from July 1 (A2361-3). F. H. Krear complains it was hampered because its representatives were forbidden access to the Fund office some time in early October, a fact which was disputed (A1091, 1431-2, 2734-7). But in any event, this

Certainly Brookhart should also have been allowed to give opinion testimony as to whether AMS and F. H. Krear were designing a system appropriate to the needs of ERISA-regulated funds. F. H. Krear's counsel in fact admitted out of the presence of the jury that Brookhart would be able to testify, after analyzing the AMS-Krear documents, that AMS was not going to be able to achieve the required objectives under the Krear contracts. Counsel stated:

> ...I think this witness has indicated that he looked at the AMS progress reports and he found they were not going to achieve the final goal of the Krear contract, and I don't think that really is too much in dispute. (Emphasis added) (A1142)

Yet the jury never heard this devastating testimony or this admission by counsel. Nor did the jury hear Brookhart testify that third-party administrators are obligated to keep the funds' records current, so that eligibility may always be determined. The court's failure to allow this testimony to go to the jury not only saved F. H. Krear but also inevitably led to a favorable verdict in behalf of Grauso. For it was Grauso's explicit function to "monitor" and report to the trustees on F. H. Krear's performance with regard to computerization (A2571). If the latter corporation was

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would have only affected the input of data, not the design of the system.

not making appropriate progress under its contracts, or if F. H. Krear was not designing an adequate system to meet the needs of the funds, the trustees should have been notified by Grauso.

F. H. Krear would also have this Court approve the ruling below prohibiting the trustees from calling an expert witnesses on the basis of its assertion that it was not given adequate notice that the trustees were dissatisfied with its performance (Brief at 27). But this issue was hotly disputed. For example, Accountant Silverberg testified he told both Weiner and Krear in mid-September that their performance was so poor that the funds were no longer in a position to determine eligibility so that participants could obtain their benefits and that it appeared John David Krear did not even know what documents were required to determine eligibility. Silverberg said that no improvements in performance followed these conversations (A856-9). F. H. Krear may have been entitled to argue that the trustees' had not given it an adequate opportunity to cure its non-performance, but it was not entitled to block the trustees from presenting their defenses. Deprived of their expert witness on the issue of performance as well as excessive costs, the trustees were at the mercy of appellees' attacks that they were mere puppets of union officials. Moreover, without the aid of expert analysis, the

trustees were incapable of convincing the jury that F. H. Krear could have only obtained its contracts with the connivance of Mozer and Grauso.

ERISA was enacted by Congress to protect the pension and welfare benefits of America's working people by requiring that such funds be operated in an efficient and cost effective manner. 29 U.S.C. §1001; Pompano v. Michael Schiavone & Sons, Inc., 680 F.2d 911 (2d Cir. 1982). The trustees were entitled to have the opportunity to prove that the appellees in this case did not live up to their obligations under ERISA and under their contracts. They were not given this opportunity and therefore the judgment below must be reversed.

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August 28, 1985

Respectfully submitted,

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