RENDERED: December 23, 1999; 2:00 p.m.
NOT TO BE PUBLISHED

Commonwealth Of Kentucky

Court Of Appeals

NO. 1998-CA-001070-MR

CITY OF LOUISVILLE AND
JOHN H. NEVIN — APPELLANTS

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE THOMAS J. KNOPF, JUDGE
ACTION NO. 90-CI-03253

POLICEMEN'S RETIREMENT FUND
OF THE CITY OF LOUISVILLE;
BOARD OF TRUSTEES OF
POLICEMEN'S RETIREMENT FUND;
BOBBY W. BRANHAM;
THOMAS H. CARRICO;
BILLY R. EPPERSON;
JOHN L. WINSTEAD, SR.; AND
BRENT O. HARDIN — APPELLEES

OPINION
AFFIRIMING IN PART - VACATING AND REMANDING IN PART
** ** ** ** **

BEFORE: BUCKINGHAM, GUIDUGLI AND SCHRODER, JUDGES.

GUIDUGLI, JUDGE. John H. Nevin and the City of Louisville (the City) appeal from several opinions and orders of the Jefferson Circuit Court which denied the City's motion to enforce a settlement agreement reached between it and the Policeman's Retirement Fund of the City of Louisville (the Fund).

The Fund was established in 1949 to provide retirement benefits to retired city police officers and their families. Due

to changes in the Fund's structure in May 1986, policemen on active duty with the City were given the option to either remain with the Fund or transfer to the County Employees Retirement System (the County fund). Many of the active duty officers chose to switch to the County fund. Due to the large shift to the County fund, the Fund now receives very few new contributions and is, for the most part, static. As a direct result, the Fund is now required to pay out approximately 12% of its principal each year in order to meet its benefit obligations to its retirees and their survivors. Because of this fact, proper management of the Fund is of utmost importance.

In April 1990, the Fund filed an action against the City claiming that it had improperly transferred $4,000,000 from the Fund to the County fund. In response to the Fund's suit, the City filed an action against the Fund alleging in part that the Fund's trustees had mismanaged the Fund by failing to monitor the actions of R. Keith Cullinan and Cullinan Associates, Inc. (Cullinan), the Fund's investment manager. The City alleged that the Trustees' inattention to Cullinan's activities cost the Fund over $5,000,000.

Shortly before the trial on the City's claims, the City and the Fund entered into a "Release and Settlement Agreement" (the Agreement) on April 7, 1995. The trial court approved the Agreement and incorporated it in full in an order entered April 10, 1995. Under the terms of the order, however, the trial court chose to "maintain supervisory jurisdiction over this action" in order to oversee enforcement of the Agreement. For

purposes of this appeal, the relevant portions of the Agreement are as follows:

> 6. FINANCIAL ADVISOR
>
> a. Within sixty (60) days after the Effective Date of this Agreement, counsel for the City and counsel for the Trustee Defendants shall agree upon the names of three persons, firms or corporations who shall agree to make presentations to the Fund to serve as the Financial Advisor to the Fund in accordance with the requirements of this paragraph. Within thirty (30) days of the selection of the three presenters, the Board of Trustees shall conduct a meeting, at which time the three presenters shall make their presentation and, at that meeting, the Board of Trustees shall select one of the three to serve as the Financial Advisor to the Fund.
>
> . . .
>
> 7. FINDINGS OF THE FINANCIAL ADVISOR
>
> a. The Financial Advisor shall have the following duties:
>
> (1) Within ninety (90) days after he or she is first selected, prepare and present in person to the Board written reports (the "Initial Reports") on the following subjects:
>
> (a) An historical evaluation of the performance of existing Fund investment managers for each time period that the Financial Advisor deems appropriate, including but not limited to, the trailing three-year and five-year periods. In addition to any other factors that Financial Advisor considers relevant, the evaluation shall include an analysis of (i) the performance of existing Fund investment managers as compared to such other investment managers as determined appropriate in writing by the Financial Advisor. The historical evaluation shall also indicate whether each Fund investment manager is among the top one-half of appropriate investment managers for the trailing three-year and five-year periods and such other longer periods as may be deemed advisable by the Financial Advisor.

. . .

(3) For each calendar quarter beginning after he presents the Initial Reports, the Financial Advisor shall present a written report on the following subjects (the "Quarterly Report") and appear in person at a meeting of the Board to discuss the Quarterly Report:

(a) An updated evaluation of the performance of the Fund investment managers as of the date of the Quarterly Report for such periods of time as the Financial Advisor considers appropriate and which must include the specific factors identified in subparagraph 7a.(1).

. . .

(5) At any time the Financial Advisor shall make such other recommendations as the Financial Advisor may deem appropriate for the good of the Fund and its beneficiaries.

. . .

c. After providing the investment manager with an opportunity to submit written comments relating to the recommendations of the Financial Advisor, the Board shall remove any Fund investment manager under the following procedure:

(1) The Financial Advisor shall recommend removal of any Fund investment manager who the Financial Advisor determines in his Initial Report, or thereafter in a Quarterly Report, is not among the top one-half of appropriate investment managers for either the trailing three-year period or the trailing five-year period. An opportunity to submit written comments shall be allowed to any affected investment manager with respect to such determinations.

(2) The Board shall remove any Fund investment manager whose removal is recommended by the Financial Advisor, provided this recommendation is accompanied by a written certification from the Financial Advisor providing the reason therefore, unless two-thirds of all of the Trustees of the Fund find and set out in the minutes of

> the Board detailed facts supporting a conclusion that special circumstances exist to disregard the recommendation of the Financial Advisor. Any such findings shall be forwarded to the Court, to the Mayor and to the President of the Board of Aldermen.

After a rather tedious selection process, James Garrels (Garrels) of Fiduciary Capital Advisors was appointed by the trial court to serve as the financial advisor pursuant to Section 6 of the Agreement. On February 24, 1997, Garrels presented his initial report as required by Section 7a.(1) of the Agreement. In his cover letter, Garrels indicated:

> We have analyzed the results on a risk-adjusted basis and also without adjusting for risk. The results should be judged primarily on a risk-adjusted basis due to the extraordinary circumstances regarding this fund and its need to pay out such a large portion of its assets every year in benefits. Reviewed in this manner, the results, I think one would agree are quite good.

In regard to Cullinan specifically, Garrels' report stated as follows:

> When compared to the stock market (S&P 500) and our universe of over 1600 equity (stock) funds, Cullinan did not fare well. For the year, Cullinan was up +17.1% (72nd percentile) vs. +22.9% for the S&P 500 (24th percentile). For the three years, Cullinan was up +10.7% per year (85th percentile) vs. 19.6% (9th percentile) for the S&P 500. The five year period was similar, with a +11.5% per year (86th percentile) vs. +15.2 (26th percentile) comparison. The bulk of the damage occurred in 1995 and 1996, as Cullinan outperformed the market in 1992 and 1993, and trailed slightly in 1994.
>
> Comparing Cullinan to a universe and policy portfolio adjusted for risk, however, produces a much more favorable comparison. Cullinan's beta (or volatility relative to the market's volatility) was .4 for the five year period, meaning that their portfolio

> return was produced with 40% of the market's risk or volatility. This means that when the market goes up, the expectation would be that Cullinan's portfolio would only go up 40% as much. Conversely, and perhaps more importantly, when the market goes down over a long period of time, the expectation would be that this portfolio would go down only 40% as much, a potentially critical factor for a fund such as this one with such a high annual payout. In addition, Cullinan's risk adjusted return produced a positive alpha of +1.3% during the 5 years which means that when adjusted for risk, the return was better than the beta alone would indicate. The covered call writing activity was the primary driver of the phenomenon.

In layman's terms, the gist of Garrels' report is that when looking at Cullinan's performance on a non risk-adjusted basis, Cullinan was "not among the top one-half of appropriate investment managers for either the trailing three-year period or the trailing five-year period" as required for his retention pursuant to Section 7c.(1) of the Agreement. However, when looking at Cullinan's performance on a risk-adjusted basis, Cullinan's performance was within the upper one-half.

Garrels' report also contained a section entitled "Statement of Investment Policy Guidelines and Objectives." Sections VII and VIII of that section of Garrels' report read as follows:

> VII. MANAGER PERFORMANCE
>
> 1. Manager performance shall be monitored using a three to five year moving average and performance will be compared to:
>
> a. An unmanaged market index fund.
>
> b. A relative return target of the top 50% of the Consultant's manager universe, (or other representative

> universe approved by The Board) with some consistency.
>
> c. An absolute return target of the Consumer Price Index plus 4% compounded annually.

VIII. MANAGER TERMINATION

Investment managers will be considered by termination if one or more of the following occur:

> a. Major changes in professional personnel.
>
> b. Major changes in the investment process.
>
> c. There appears to be minimal probability of the manager achieving long-term investment objectives.
>
> d. The trend of the managers [sic] percentile ranking versus the consultant's universe is down.
>
> e. The trend of the manager's ranking versus his own peer group is down.

It is clear that these sections are completely at odds with the termination provisions contained in the Agreement.

It is interesting to note that aside from evaluating Cullinan's performance, Garrels makes no recommendation in this report as to whether Cullinan should be retained or terminated as investment manager.

On April 1, 1997, the City filed a motion with the trial court seeking to enforce the Agreement. Specifically, the City sought an order compelling Garrels to recommend the termination of Cullinan pursuant to Section 7 c.(1) due to his failure to meet the performance requirements outlined in the

Agreement. The City alleged that the Agreement called for a direct comparison in evaluating Cullinan's performance as opposed to one adjusted for risk, and maintained that because Cullinan's performance in the direct comparison did not meet the expectations contained in the Agreement Garrels was bound to recommend his removal. The City also sought a declaration by the trial court that Sections VII and VIII of Garrel's initial report be deemed to be improper as they constituted additional requirements not otherwise included in the Agreement between the City and the Fund.

The trial court held two hearings on the City's motion. Subsequent to the May 5, 1997 hearing, Garrels submitted his quarterly report for the quarter ending June 30, 1997. It is clear from this report that even after adjusting Cullinan's performance for risk, he was not meeting the performance requirements set forth in the Agreement. As to whether Cullinan should be removed as investment manager, Garrels stated:

> Investment Manager Termination
>
> Over the past five years, Fidelity Capital Advisors, Inc. has recommended the termination of at least one investment manager for each of its clients. The reasons for termination were the same as the ones listed in our current statement of investment policy, guidelines, and objectives:
>
> 1. Change in key people.
>
> 2. Substantive change in investment process.
>
> 3. A perception that the investment manager had underperformed to such a degree that achieving the objective was highly unlikely within a reasonable

time frame without the investment manager taking undue risk.

4. The trend of percentile rankings for the investment manager was down when compared to all other investment managers in the general universe.

5. The trend of percentile rankings was down for the investment manager when compared to a universe of that investment manager's peers.

In each case, the reasons for termination varied, and in some cases, more than one of the reasons applied. In no case were these conditions applied arbitrarily in the sense that as soon as one of the conditions applied the manager was terminated, but rather the manager became subject to review for termination.

In the case at hand, the settlement agreement requires the Financial Advisor to recommend the termination of any investment manager whose investment return falls below the median return as measured at the end of any quarter for that manager's universe (said universe as determined by the Financial Advisor), for the trailing three or five year period. Such is currently the case with Cullinan Associates for the past two quarters. The settlement agreement might as well have had this stipulation without any recommendation by the Financial Advisor since it, in effect, removes the ability of the Financial Advisor to exercise any discretion or judgment as it relates to such a recommendation. Each of our clients operates under its own set of circumstances. The aforementioned conditions for review for termination of any investment manager must be applied within the context of each. Some of the relevant circumstances of this fund:

Actuarial investment return assumption is a relatively high 8.5%.

Annual payout to beneficiaries in effect means a loss of principal value to the fund of 11-12% per year if the fund's return is

> zero since no new "active" contributing participants are joining the fund. Herein lies the crux of the investing problem since bonds do not yield (they have not for some time, current U.S. government long term bonds yield around 6.5%) nor have they returned the required 8.5%. This necessitates investment of plan assets in the stock market. The danger here, however, is that the stock market's volatility coupled with the fund's onerous payout requirement could create a "double whammy", seriously eroding plan assets during a protracted market decline (double digit, longer than one year). Consequently, a lower risk method of investing is mandated. This means that the focus should be downside risk protection. By definition, acknowledgment of this fact means acceptance of significant opportunity risk, meaning that outperformance on the upside of a protracted market advance (the current advance now fifteen years old) is highly unlikely.
>
> In the case of Cullinan Associates, they have performed exactly as one would expect in the current environment and have produced returns far in excess of the actuarial requirement with significantly lower risk, enabling the fund's commitment to stocks (and its return) to be higher than it would have been with a more traditional approach (more bonds, less stock). Because the overall objectives of the fund are being met and Cullinan has managed the assets under his control precisely as expected, both in terms of return and risk, we cannot in good conscience recommend their termination at this time, particularly in light of the fact that the stock market's having compounded at a rate 50% higher or more than its long-term rate (around 10%) for the past 5, 10, and 15 years.

Upon receipt of Garrels' quarterly report, the City moved to supplement its motion with Garrels' second report, and once again asked that Garrels be ordered to recommend Cullinan's removal due to the fact that it was not performing up to

expectations of the Agreement even when its performance was adjusted for risk.

On February 4, 1998, the trial court entered an opinion and order denying the City's motion to enforce the Agreement. In so holding, the trial court focused only on Garrels' initial report and reasoned:

> Even though Section 7a(1)(a) provides that Garrels had to indicate in his initial report whether an investment manager was among the top one-half of appropriate investment managers for the trailing three-year and five-year periods, Garrels could also include any additional factors he considered relevant. While Section 7c(1) requires Garrels to recommend the removal of any investment manager he determined in his initial report to not be among the top one-half of said appropriate investment managers, Section 7a(5) however requires Garrels to make, at any time, any recommendation he deems appropriate for the good of the Fund.
>
> Based upon the language of the settlement agreement when read as a whole and interpreted in harmony so as to give effect to all the provisions of Section 7, the Court finds that Garrels had the authority and capability to recommend that Cullinan's performance be adjusted for risk in order to be evaluated. As Garrels testified at the May 5, 1997 hearing, he felt that the use of covered call options by Cullinan was a good thing for the Fund, given its suspended nature and high payout.

The trial court also stated:

> To eliminate any further dispute over the quality of Cullinan's performance as an investment manager for the Fund, this Court strongly encourages the Board of Trustees of the Fund to adopt Garrels' recommended risk adjusted method (Beta, Alpha, R2, and Standard Deviation) as the stated standard to be uniformly used in evaluating and ranking Cullinan's performance.

The trial court did not address the City's concerns regarding Garrels' second report until it entered a subsequent opinion and order on April 17, 1998 in response to the City's motion to make additional findings of fact and/or to alter or amend its order of February 4, 1998. In finding that a recommendation from Garrels that Cullinan be removed as investment manager was still not warranted, the trial court stated:

> In the June 30, 1997 quarterly report, Garrels stated that Cullinan has for two quarters fallen below the median return for the trailing three or five-year period. However, he stated that Cullinan performed exactly as expected in the current environment and produced returns far in excess of the actuarial requirement with significantly lower risk. He further stated that because the Fund's overall objectives were being met and Cullinan had managed the assets under its control precisely as expected, both in terms of return and risk, he could not in good conscience recommend Cullinan's termination at that time, particularly in light of the fact that the stock market has compounded at a rate 50% higher or more than its long-term rate for the past five, ten, and fifteen years.
>
> By letter dated January 27, 1998, Garrels set forth Cullinan's percentile rankings for the quarter ending December 31, 1997, wherein Cullinan was now above the median for all time periods "reflecting the capricious nature of relative universes and what the addition of a good quarter and the deletion of a relatively poor one can do." He further stated that with such attractive absolute returns, it would be difficult to make a case to terminate Cullinan at this time.
>
> The construction, meaning, and legal effect of a written instrument are generally matters of law for the Court. Morganfield National Bank v. Damien Elder & Sons, Ky., 836 S.W.2d 893 (1992). As the Court found in its prior opinion of February 4, 1998, the settlement

> agreement requires a written report, initially and on a quarterly basis, which includes the percentages for the trailing three and five-year periods and any other factors considered relevant by the financial advisor.[emphasis omitted] See Section 7a(3). . . . Section 7a(5) states that the Financial Advisor shall make such other recommendations he/she deems appropriate for the good of the Fund [emphasis omitted].
>
> The Court finds that based upon the language of the settlement agreement when read as whole and interpreted in harmony so as to give effect to all the provisions of Section 7, Garrels had the discretion to recommend in the March 1997 and June, 1997 quarterly reports that Cullinan be kept as a [sic] investment manager with the Fund if he deemed it appropriate for the good of the Fund and its beneficiaries.

This appeal followed.

The City contends that in refusing to compel Garrels to recommend Cullinan's termination as investment manager due to his failure to satisfy the performance requirements of the Agreement, the trial court has failed to enforce the express language of the Agreement. We note at the outset that in construing the obligations of parties to a contract, "it is not the function of the judiciary to change the obligations of a contract which the parties have seen fit to make." O.P. Link Handle Company v. Wright, Ky., 429 S.W.2d 842, 847 (1968). "It is hornbook law that the courts will not make a contract for the parties; it will only interpret and enforce the contract which the parties themselves have made." Haldeman v. Haldeman, Ky., 197 S.W. 376, 379 (1917).

Any interpretation of the Agreement between the City and the Fund depends on how Section 7a.(5), which allows the Financial Advisor "to make such other recommendations as [he] may

deem appropriate for the good of the Fund," is interpreted in light of Section 7c.(1), which requires that "the Financial Advisor shall recommend removal of any Fund investment manager who . . . is not among the top one-half of appropriate investment managers" (emphasis added) for certain specified periods of time. In holding that Section 7a.(5) gives the Financial Advisor discretion to not recommend termination of an investment manager who has failed to meet the performance requirements of the Agreement, we believe that the trial court has improperly changed the obligations set forth in the Agreement. There are several grounds on which we base our decision.

Under Section 7a. of the Agreement, the duties of the Financial Advisor are set forth. Pursuant to that section, the Financial Advisor is required to submit an initial report followed by monthly, quarterly, and yearly reports, all of which are required to contain certain enumerated items and recommendations. At the end of Section 7a. is (5), which allows the Financial Advisor to make other recommendations "at any time which he deems appropriate." We believe that the discretion granted in Section 7a.(5) extends only to the reports allowed under the provisions of Section 7a., and further find that it gives the Financial Advisor the discretion to make recommendations at any time he see fit, and not just in conjunction with the reports he is required to issue.

A prime example of the discretion allowed the Financial Advisor under this section is Garrels' decision to use a risk-adjusted basis for evaluating Cullinan's performance. Contrary

to the City's assertion, there is nothing in the language of the Agreement which requires the Financial Advisor to utilize a direct heads-on comparison with other financial investment managers. In fact under Section 7a.(1)(a), the evaluation analysis is to include an evaluation of "the performance of existing Fund investment managers as compared to such other investment managers as determined appropriate in writing by the Financial Advisor." [emphasis added] Hence, under the terms of the language it was appropriate for Garrels to recommend that Cullinan's performance be evaluated on a risk adjusted basis if that is what he believed to be appropriate for the good of the Fund. Because the initial report prepared by Garrels showed that Cullinan met his performance requirements under the Agreement based on the risk adjusted measurement, the trial court was correct in holding in its opinion and order of February 2, 1998 that a recommendation calling for Cullinan's removal was not warranted.

However, the discretion granted by the Financial Advisor under Section 7a.(5) does not extend so far as to allow him to avoid recommending termination of an investment manager whose performance does not meet the requirements set forth in the Agreement. Furthermore, it does not allow the Financial Advisor to ignore the performance requirements of the Agreement in favor of his own criteria in determining whether to recommend removal of an investment manager as it appears Garrels has done in this case. Under Section 7c.(1), it is clearly stated that "[t]he Financial Advisor shall recommend removal of any Fund investment

manager" [emphasis added] once he determines in either an initial or quarterly report that the person is not meeting the performance requirements set forth under the Agreement. We believe that the use of the word "shall" in the Agreement dictates such a result. In fact, it appears that even Garrels recognized that this recommendation requirement was not discretionary in his quarterly report.

Further support for our conclusion can be found in Section 7c.(2), which clearly places the discretion as to whether to remove an investment manager with the Fund's Board of Trustees. As provided by that section, once the Financial Advisor has recommended the removal of the investment manager, it is the Board who must decide whether or not to accept the recommendation. The Board is not compelled to accept the recommendation of the Financial Advisor, and may choose to retain an investment manager in light of the Financial Advisor's recommendation to the contrary if it so chooses.

We recognize that the trial court has taken an active interest in doing what is best for the Fund and its beneficiaries and commend the trial court for its handling of what has truly become a contentious and highly technical case. We also agree with the trial court's reasoning that the removal of Cullinan as Fund investment manager is more than likely not in the best interest of the Fund based on the analysis set forth in Garrels' quarterly report. However, this does not alter the fact that under Wright and Haldeman, the trial court is not permitted to substitute what it feels is the proper solution for what is

clearly called for under the terms of the Agreement. Because the terms of the Agreement clearly and unequivocally call for Garrels to recommend Cullinan's termination when he is not meeting the performance requirements contained in the Agreement between the City and the Fund, the trial court erred in finding otherwise in light of the findings contained in Garrels' quarterly report.

Because we find that the trial court erred in not enforcing the terms of the Agreement between the City and the Fund, we need not address the City's arguments considering the propriety of the trial court's refusal to consider the testimony of its expert witness as presented at the May 5, 1998, hearing on the City's motion. The testimony presented by the expert has no bearing on the outcome of our decision.

Having considered the parties' argument on appeal, the opinion and order of the Jefferson Circuit Court entered February 2, 1998, is affirmed to the extent that it finds that Garrels was not required to recommend the termination of Cullinan as investment manager based on his initial report. The opinion and order of the trial court entered April 17, 1998, is vacated, and this matter is remanded for further proceedings in accordance with the terms of this opinion.

ALL CONCUR.

BRIEF FOR APPELLANT:

Donald L. Cox
Mary Janice Lintner
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BRIEF FOR APPELLEES:

O. Grant Bruton
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