COMMONWEALTH OF KENTUCKY
COUNTY OF FRANKLIN CIRCUIT COURT

CASE NO. 17-CI-1348

DIVISION ONE

JEFFREY C. MAYBERRY, et al. **PLAINTIFFS**

v.

PLAINTIFFS' COMBINED REPLY TO RESPONSE TO MOTION TO STRIKE OF HEDGE FUND SELLERS REGARDING INVALIDITY OF LLC AGREEMENTS[1]

KKR & CO., L.P., ET AL. **DEFENDANTS**

ELECTRONICALLY FILED

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INTRODUCTION

Plaintiffs' FAC alleged the Hedge Fund Sellers ("HFS") owed and breached Kentucky law-based fiduciary duties to KRS (FAC ¶¶34(d), 164, 183, 309-17), including acts that "constituted willful and wonton conduct, gross negligence and malice and oppression." FAC ¶¶318-23. As a defense, at the pleading stage, the HFS offered up unpleaded LLC Agreements and related Subscription Agreements – seeking to ***enforce them*** as a defense and limit their liability to acts of bad faith and gross negligence which they then argue have not been adequately pleaded – requiring dismissal of the FAC. Plaintiffs have moved to strike these Agreements. The Agreements are not the basis of Plaintiffs' legal claims and were neither

[1] This Reply is supplemented by a contemporaneously-filed Plaintiffs' Combined Reply to Response to Motion to Strike of Cavanaugh Macdonald, BAAM and PAAMCO Generally.

attached to nor incorporated by reference in the FAC, and they should be stricken. *See* Plaintiffs' Combined Reply to Response to Motion to Strike of Cavanaugh Macdonald, BAAM and PAAMCO Generally. This Reply focuses specifically on issues going to the invalidity and/or unenforceability of these Agreements – issues that can only be adjudicated after discovery and on a fully-developed record, not as Defendants seek in a truncated proceeding in which their validity, enforceability, and thus relevance are simply assumed.

It is false and disingenuous to suggest, as the HFS do, that these LLC Agreements were public or easily accessible to the public when the FAC was filed and were somehow deliberately avoided or concealed by Plaintiffs in pleading their FAC. This is simply false. The LLC Agreements were secret and claimed to be HFS "trade secrets" at the insistence of the HFS – presumably to hide, *inter alia*, secret proprietary investment techniques so stellar they produced returns of less than KRS' cash in the bank had earned[2] while generating hundreds of millions in fees.[3] To suggest, as BAAM does, that Plaintiffs actually had access to these agreements

[2] *See* KRS CAFR 2009, Ex. 24 to Plaintiffs' Opposition to Motion to Dismiss Companion Memo ("Companion Memo"); *see also* Simon Lack *The Hedge Fund Mirage*, *The Illusion of Big Money and Why It's Too Good to Be True,* (Wiley Publishers 2012) ("If all the money that's ever been invested in hedge funds had been put in treasury bills instead, the results would have been twice as good … it's a truly amazing statistic").

[3] *See, e.g.,* Prisma LLC Agreement ¶7.4(c) and definition of "Manager Confidential Information" at p. 33. *See also,* "trade secrets" language in ¶7.4(e)(vi). It is further worth recalling the positions taken by the HFS as to trade secrets and confidentiality at the recent April 17, 2018 hearing herein.

(*See* BAAM Response at 10) is equally wrong and misleading.[4]

There is no need at this time for the Court to determine the validity or enforceability of the LLC Agreements, and it would be inappropriate to do so in the absence of discovery and without proper context. When the LLC Agreements are considered later on, in a proper procedural setting and after appropriate discovery, their provisions purporting to constrict the HFS fiduciary duties to KRS or their liability for any breach are likely to be deemed unenforceable or void, while other provisions in the LLC Agreements actually appear to recognize the imposition of fiduciary duty liability on the HFS under Kentucky law.

As explained below, under Kentucky law the HFS owed fiduciary duties to KRS and to its members and beneficiaries. They were required by law to carry out these duties "solely in the interest of [KRS'] members and beneficiaries." Attempts by the HFS to dilute the force or effect of these duties, or to require KRS to waive (on its own behalf and/or on behalf of its "members and beneficiaries") any of the protections to which it was entitled as a result of these ***sole interest*** fiduciary duties – whether premised on Delaware law (which seems in this instance to be at odds with Kentucky law) or their interpretation of the LLC Agreements – must at a minimum be examined by the Court on a full factual record. Plaintiffs are confident that, upon such examination, the offending provisions of these agreements will be

[4] Plaintiffs pleaded, on information and belief, that "limited partnership" (not LLC) contracts existed, but they had no prior access to the agreements precisely because of the HFS' obsession with secrecy. *See* FAC ¶38. BAAM's comment about Plaintiffs' Companion Memo does not alter this reality; of course Plaintiffs had the LLC ***after*** the HFS improperly filed them with the Court.

deemed void or unenforceable.

In any event, unpleaded documents of dubious legality, which do not form the basis of Plaintiffs' legal claims and which contain internally inconsistent provisions are not a proper basis to dismiss Plaintiffs' otherwise well-pleaded FAC. *See* Plaintiffs' Combined Reply to Response to Motion to Strike of Cavanaugh Macdonald, BAAM and PAAMCO Generally.

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I. THE UNPLEADED LLC AGREEMENTS' PROVISIONS PURPORTING TO CONSTRICT THE HFS' FIDUCIARY OBLIGATIONS OR LIMIT THEIR LIABILITY ARE LIKELY UNENFORCEABLE OR VOID

To try to dilute or evade the full force of their fiduciary duties and liability for their breach under Kentucky law (discussed in detail at Section IV, *infra*), the HFS placed provisions in the LLC Agreements – so called "hedge clauses" – containing language they assert allows them to evade or dilute their fiduciary duties to KRS or limit KRS' legal rights. Further, through the so-called Subscription Agreements, the HFS attempted to evade any responsibility for the "suitability" obligations that are part and parcel of their fiduciary duties, in an effort to have KRS in effect waive fiduciary protection due under law. However, ***these fiduciary duties are non-dilutable non-evadable legal obligations imposed on investment advisers like the HFS under both federal and Kentucky law***.

A. Federal Law

The HFS are each Registered Investment Advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). *See* Companion Memo, at 2-5.[5] As such, as they themselves admit, they owe fiduciary duties to their customers. *Id.* A Registered Investment Adviser not only owes fiduciary duties to its clients, it is prohibited by §215 of the Advisers Act from obtaining or enforcing any contractual provision to dilute the level of its fiduciary obligations or the extent of liability for

[5] The HFS were each required to be registered advisers under the Advisers Act and to assume fiduciary duties to KRS in order to be allowed to sell investment products to KRS. *See* Companion Memo, at 5-8.

any breach. The Supreme Court made this clear in *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis,* 444 U.S. 11 (1979).

Transamerica involved a derivative action brought on behalf of a trust alleging violations of the Advisers Act, seeking injunctive relief, rescission, and other relief. The Court was asked to decide if the investor had an implied private right of action to sue for damages or other relief under the Advisers Act:

> Accordingly, we begin with the language of the statute itself.... It is asserted that the creation of a private right of action can fairly be inferred from the language of two sections of the Act. The first is §206, which broadly proscribes fraudulent practices by investment advisers, making it unlawful for any investment adviser "to employ any device, scheme, or artifice to defraud ... [or] to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," .... The second is ***§215, which provides that contracts whose formation or performance would violate the Act*** "***shall be void ... as regards the rights of" the violator and knowing successors in interest***."[6]

Id. at 16-17. Section 215 of the Advisers Act, Validity of Contracts, provides:

> ***(a) Waiver of compliance as void***
> ***Any condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void.***[7]
> **(b) Rights affected by invalidity**
> Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void....

15 U.S.C. §80b-15. The *Transamerica* Court elaborated:

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6 Emphases added, unless indicated otherwise.

7 §2.4 of the PAAMCO and §2.3 of the Blackstone and Prisma/KKR LLC Agreements are naked limitation of liability provisions. Indeed they are all entitled "Limitation of Liability."

> In the case of §215, we conclude that the statutory language itself fairly implies a right to specific and limited relief in a federal court. By declaring certain contracts void, §215 by its terms necessarily contemplates that the issue of voidness under its criteria may be litigated somewhere. ***At the very least Congress must have assumed that §215 could be raised defensively in private litigation to preclude the enforcement of an investment advisers contract***. But the legal consequences of voidness are typically not so limited. A person with the power to void a contract ordinarily may resort to a court to have the contract rescinded and to obtain restitution of consideration paid.
>
> * * *
>
> For these reasons we conclude that when Congress declared in §215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution.

Transamerica, 444 U.S. at 18-19.

To be clear – Plaintiffs assert no claim, cause of action, or relief under or based on the Advisers Act. All claims asserted arise under Kentucky law. First – Plaintiffs have consistently eschewed all federal claims to avoid removal. FAC ¶34. Second – there is no express or implied private right of action for damages under the Advisers Act, so Plaintiffs could not sue the HFS to recover damages for violating the Advisers Act. *Transamerica*, 444 U.S. at 16-19. ***Plaintiffs continue to assert no federal law claims***.

Plaintiffs could have filed a separate declaratory relief action in federal court under *Transamerica* to void the LLC Agreements or preclude "enforcement" of their offending provisions. However, Plaintiffs need not do so. There is no requirement – practical or legal – for a separate suit in a different court to determine the validity or enforceability of the LLC Agreements. The HFS have raised the LLC Agreements in this court, albeit prematurely. However, the HFS cannot assert liability-limiting

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provisions that are void or voidable under federal (and state law, discussed below) as a defense to Plaintiffs' (or KRS') state law breach of fiduciary duty claims; as the Supreme Court stated, "§***215 could be raised defensively in private litigation to preclude the enforcement of an investment adviser's contract***." *Transamerica*, 444 U.S. at 19. By raising the LLC Agreements, the HFS are attempting to ***enforce*** the LLC Agreements and obtain dismissal of valid Kentucky law fiduciary duty claims.

B. Kentucky Law

These offending LLC Agreements – and their liability-limiting clauses – are also inconsistent with Kentucky pension, securities and common law.[8] Kentucky pension law imposes fiduciary duties on "trustees … and other fiduciaries," and requires that those duties be "discharged … [s]olely in the interest of the members and beneficiaries." KRS 61.650(1)(c). Moreover, as pointed out in Plaintiff's Companion Memo, the HFS were also required to be fiduciaries, with the same "solely in the interest of" standard, under the KFS Investment Policy, which has the

[8] Under the Kentucky securities laws, an investment adviser as defined by KRS 292.310(11) is a fiduciary pursuant to 808 KAR 10:450, which also sets forth in detail actions constituting a breach of fiduciary duty by an investment adviser:

> [T]he following shall be considered either a "breach of fiduciary duty or a dishonest and unethical practice."
>
> "(19) Including in an advisory contract any condition, stipulation, or provision binding any client to waive compliance with any provision of the Securities Act of Kentucky, KRS Chapter 292, 808 Chapter 10, or of the Investment Advisors Act of 1940, 15 U.S.C. 80b;"

The mere existence of the regulations, whether it applies or not to HFS, shows the use of such exculpatory provisions is highly dubious under any circumstances by investment advisers in Kentucky.

force of an administrative regulation, *i.e.*, force of law. Kentucky common law, particularly in the trust arena, also maintains its traditional view of the duties of trustees and related fiduciaries. That is a critical piece here, as Plaintiffs have alleged (and the evidence to date, such as PAAMCO's "trusted advisor" memo, has confirmed) that the HFS owed common law fiduciary duties to KRS well before they presented the LLC and Subscription Agreements, with their "hedge clauses" and the like.

There simply is no place in this "solely in the interest of" fiduciary regime for self-serving contractual carve-outs designed to eliminate or shift traditional duties of care, loyalty or good faith, while paying lip service to a shrunken form of "fiduciary duty."

For present purposes, it is sufficient to say: (1) the LLC Agreements are not properly before the Court on the Rule 12 motions to dismiss, having neither been pleaded nor incorporated by reference into the FAC,[9] nor central to Plaintiffs' claims nor public; (2) if and when the LLC Agreements are properly before the Court by way of the HFS' answers or otherwise, Plaintiffs will attack their validity and/or the enforceability of their offending provisions in an appropriate manner, as anticipated by *Transamerica*; and (3) even if the void/unenforceable "gross negligence"/"bad faith" heightened liability standard language contained in the unpleaded LLC

[9] The only reference to these contracts in the FAC is the general statement, made on information and belief, that the Black Boxes "were structured as limited partnerships using detailed contracts" signed in Kentucky, in the FAC's jurisdictional allegations. *See* FAC ¶38.

Agreement "hedge clauses" apply at the pleading stage, the FAC adequately alleges gross negligence and bad faith given its allegations of predatory targeting of KRS by the HFS (FAC ¶¶14, 17-19, 43), their knowingly selling KRS unsuitable, excessively risky and expensive Black Boxes (FAC ¶¶164, 183), and the allegations in COUNT V, Punitive Damages, of willful and wanton conduct, gross negligence, malice, oppression and bad faith, etc. (FAC ¶319). *See* Opposition to Motion to Dismiss at pp. vi-viii.

However, going forward in this case, the emergence of the previously secreted LLC Agreements, and the HFS' assertion of their void/unenforceable "hedge clauses" in an attempt to block or dilute valid state law fiduciary duty claims, raises several serious issues. Discovery may reveal a game is be being played by the sophisticated HFS and their lawyers to get public pension funds to systematically waive or dilute the protections and obligations those Funds are guaranteed from their investment advisers under the Advisers Act and applicable state law. If the HFS are doing this to other public funds across the U.S. as well[10] – *i.e.* using "hedge clauses" to take advantage of their public fund clients to whom they owe the fiduciary duty ***to not do that very thing*** – then they may be engaged in an ongoing course of business in violation of nationwide-applicable law (*i.e.,* evading §215 of the Advisers Act) and here, similar Kentucky provisions. Discovery into the HFS'

[10] The eerie similarities of the unlawful language in the separate LLC Agreements suggests an industrywide practice of systemic evasion or dilution of these federal protections, raising other legal issues. KKR and Blackstone have previously been sued for antitrust violations in connection with their private equity operations and paid hundreds of millions to settle. *See* Companion Memo, at 42-43.

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business practices regarding public funds nationwide will throw more light on this part of their business model. And if and when this course of conduct is proven here, it will expose the HFS to punitive damages. *See* FAC Count V.[11]

II. THE UNPLEADED LLC AGREEMENTS CONTAIN OTHER CONTRADICTORY PROVISIONS RECOGNIZING THE HFS' FIDUCIARY DUTIES AND LIABILITIES TO KRS UNDER KENTUCKY LAW

The impropriety of submitting these unpleaded LLC Agreements to seek dismissal of the FAC is further demonstrated by their ambiguity, if not outright inconsistency, as each of the unpleaded LLC Agreements contain contradictory and confusing provisions that explicitly recognize the HFS' "fiduciary duties" and obligations to "comply with" Kentucky law and that hold HFS liable even for "good faith" actions (*i.e.* liability not just limited to bad faith actions).

Blackstone §2.4

> Section 2.4 Standard of Care. With respect to the performance of its duties and responsibilities hereunder, ***the Manager will comply with all material applicable laws and regulations*** including applicable Securities and Commodities Laws. ***The Manager agrees that it owes fiduciary duties and responsibilities to the Company under the Advisers Act***.

Prisma KKR §2.4

> Section 2.4 Standard of Care. With respect to the performance of its duties and responsibilities hereunder, ***the Manager will comply with all applicable laws and regulations***, including applicable Securities and Commodities Laws, and the Manager will exercise the case, skill, prudence and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. ***The Manager agrees that it owes fiduciary duties and responsibilities***

[11] As the Companion Memo shows, KKR and Blackstone are already serial violators of the fiduciary duties imposed on them by the Advisers Act. *Id*. at 43-44.

to the Company.

PAAMCO §2.5(j)

(j) The U.S. federal and state securities laws impose liabilities under certain circumstances on Persons who act in good faith, and therefore ***nothing in this Agreement waives or limits any rights that the Company or a Member hay have against the Manager or Manager Associate under those laws***.

"All applicable laws and regulations" and "state securities laws" presumably includes Kentucky laws and regulations. Whatever these "standard of care" provisions in the LLC Agreements mean, we know this: (1) in Blackstone's and Prisma's case, they explicitly acknowledge that the HFS owe KRS the very fiduciary duties they now try to deny or dilute, and (2) in PAAMCO's case, that KRS had not waived its rights to enforce liability claims based on "good faith" conduct, *i.e.* a breach of the affirmative obligations that are included in fiduciary duties.[12]

This confusing combination of void, unenforceable, contradictory and inconsistent provisions in the unpleaded LLC Agreements regarding the HFS' fiduciary duties and liability for their breach to KRS render those LLC Agreements utterly useless vehicles to obtain dismissal of a complaint under Kentucky's strict Rule 12 dismissal requirements that no possible set of facts could be proven under the allegations entitling Plaintiffs to any relief. *See* Opposition to Motions to Dismiss.

[12] These provisions acknowledging fiduciary duties are consistent with the KRS Investment Policy Manual requiring the HFS to be Registered Investment Advisers and to assume fiduciary duties to KRS. *See* Companion Memo, at 6-7.

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III. THE HFS OWED KRS A FULL RANGE OF UNDILUTED AFFIRMATIVE FIDUCIARY DUTIES OF CARE, LOYALTY AND FAIR DEALING UNDER KENTUCKY COMMON LAW

Why are the HFS attempting to improperly assert the unpleaded LLC Agreements at the Rule 12 stage? The HFS are doing this to avoid the consequences of the ***affirmative fiduciary obligations*** of good faith, fidelity, care, suitability, honesty, avoidance of overreaching or taking advantage of KRS arising under Kentucky law, which, when considered in light of the limited evidence presented in the Companion Memo – without any discovery yet as to KKR or Blackstone – shows that their conduct can never satisfy those standards. *See SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963) (defining an investment advisor's fiduciary duty as "***affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading [his or her] clients***"); *see also* Thomas P. Lemke and Gerald T. Lins, Securities Law Handbook Series: Regulation of Investment Advisors, (Thomas West 2008) ("***the purpose of the duty is to eliminate conflicts of interest and to prevent an advisor from overreaching or taking unfair advantage of a client's trust***").

A recent Harvard Business Law Review article discussed state common law fiduciary duties as the source and origin of those outlined in the Advisers Act:

> State common law is the historical source of the fiduciary duty in the United States…. Significantly, fiduciaries are distinguished from most other business practitioners in two ways. They typical business practitioner is only subject to a commercial standard of conduct. Fiduciaries, however, possess the technical expertise, experience, and specialized knowledge that equip them to render advice with the care of a prudent person vested with such skills. In addition, they are bound by

> an undivided loyalty to their client. In short, fiduciaries owe their clients a duty of care and a duty of loyalty, which exceed the typical business practitioner's commercial standard of conduct.
>
> * * *
>
> ***Prior to the passage of the Advisers Act, investment advisers were fiduciaries under state common law.*** As investments experts, investment advisers conferred a benefit on society by bridging the knowledge gap between themselves and the average American over wealth generation and capital formation. Because society viewed generating wealth and forming capital to be vital to the economy, while recognizing the potential for abuse by unscrupulous investment advisers, state law determined that it was in the public interest to impose fiduciary duties on investment advisers as experts.

J. Tyler Kirk, *A Federal Fiduciary Standard Under the Investment Advisers Act of 1940: A Refinement for the Protection of Private Funds*, Harvard Business Law Review Online, Vol. 7, at 19 (Dec. 6, 2016), *available at* http://www.hblr.org/2016/12/a-federal-fiduciary-standard-under-the-investment-advisers-act-of-1940-a-refinement-for-the-protection-of-private-funds/.

Part of the common law origins of fiduciary duties are found in the law of trusts. That common law of trusts provided the "strict standards of trustee conduct" embodied in ERISA (the federal legislation that regulates and protects corporate and similar pensions) and defines the duties of ERISA plan fiduciaries.[13] *See Central States, Southeast and Southwest Areas Pension Fund v. Central Transport, Inc.,* 472 U.S. 559 (1985); *see also Tibble v. Edison International,* 135 S. Ct. 1823 (2015) ("We have often noted that an ERISA fiduciary's duty is 'derived from the common law of trusts.' (citations omitted). In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts."). These trust-related

[13] When enacting ERISA, Congress chose not to regulate state pension plans.

fiduciary duties include ***affirmative obligations*** to act "***solely in the interest of the participants***" ***and with reasonable "care, skill, prudence and diligence"*** because ***"one of the fundamental common-law duties a trustee is to preserve and maintain trust assets***." *Central States,* 472 U.S. at 571-2.

In a manner similar to ERISA's importation of common law trust principles into the ERISA federal pension plan fiduciary duty context, the Advisers Act created federal fiduciary standards for investment advisers that were based on ***existing*** common law fiduciary rules for financial advisers. *See Transamerica*, 444 U.S. at 17 ("we have previously recognized, 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers") (citations omitted). In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Court explained the common law origins of the Advisers Act's "federal fiduciary standards" in the context of holding those standards broadly prohibited all types of fraudulent practices but did not require proof of intent to deceive. The Court quoted the original "declaration of policy" behind the Advisers Act:

> "it is hereby declared that the national public interest and the interest of investors are adversely affected … when the business of investment advisers is so conducted … ***to enable such advisers to relieve themselves of their fiduciary obligations to their clients***." "It is hereby declared that the policy and purposes of this title … are to … eliminate the abuses enumerated in this section."

Id. at 189-90. The Court continued:

> The Investment Advisers Act of 1940 thus reflects a congressional recognition "***of the delicate fiduciary nature of an investment advisory relationship***," as well as a congressional intent to eliminate … all conflicts of interest which might incline as investment adviser – consciously or unconsciously – ***to render advice which was not disinterested***….

> This conclusion moreover, is not in derogation of the common law of fraud.... To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society.

Id. at 191-92.

In detailing the broad, strict affirmative fiduciary duties of a financial adviser, the SEC also noted the common law origin of the "federal fiduciary standards" of the Advisers Act:

> Fundamental to the Act is the notion that an adviser is a fiduciary. ***As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss***. The landmark court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:
>
> > Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

See Regulation of Investment Advisers by the Securities and Exchange Commission, National Institute, 2001N01BFIB ABA-LGLED F-1 (November 8-10, 2001), *available at* https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

The common law fiduciary duties that were incorporated into ERISA for pension fiduciaries and into the Advisers Act for investment adviser fiduciaries under federal law are common law fiduciary obligations of the type that exist for

fiduciaries under Kentucky law and upon which Plaintiffs rely in this case.

Kentucky pension law incorporates these traditional notions of full-throated fiduciary duties, and imposes them on every "trustee, officer, employee, or other fiduciary" dealing with the retirement system. KRS 61.650(1)(c). The HFS are among those "other fiduciaries" as a matter of Kentucky law. Thus, they were required to "discharge [their] duties with respect to the retirement system … [s]olely in the interest of the members and beneficiaries…." *Id*. These fiduciaries were not permitted to attempt, by contract, to reduce the force or effect of these duties. At a minimum, this Court must examine, ***on a full record***, whether the HFS' attempt to "choose" Delaware law in an effort to reduce the force and effect of their own fiduciary duties is at odds with Kentucky pension and other law, as it certainly seems to be.

Kentucky common law is to the same effect. *See Steelvest, Inc., v. Scansteel Services Ctr*., 807 S.W.2d 476 (1991), in which plaintiff alleged breaches of implied fiduciary duties by different defendants, including corporate employees and a financial institution. In recognizing the existence of these implied fiduciary duties, the Court noted, "the tendency of the law, both legislature and common, has been in the direction of enforcing increasingly high standards of fairness or commercial morality in trade" and then made it clear that those fiduciary duties not only included prohibitions against bad acts – *i.e.* acting "against the [beneficiary's] interest," but also imposed affirmative duties "of loyalty and faithfulness" and to act "in good faith and with due regard for the interest of the one requiring confidence,"

noting even "passive" conduct could violate the fiduciary's duties. *Steelvest,* 807 S.W.2d at 483-5.

These are the full, ***undiluted*** fiduciary duties owed to KRS under Kentucky law in this litigation – not some watered-down version reflecting nothing more than the morals of the Wall Street marketplace that were crafted by the HFS' high-powered lawyers to prefer the HFS, limit their duties and liabilities, and disadvantage KRS by requiring KRS to prove gross negligence and bad faith.

The FAC alleges in great detail that the HFS knowingly sold $1.5 billion in unsuitable, ultra-high risk[14], super high fee Black Box hedge funds to KRS – a seriously underfunded Pension Plan – whose Trustees had just been explicitly warned:

- There was "no reasonable investment strategy…that would allow the Plan to invest its way to significantly improved financial status"
- There was "no investment strategy that offers the probability of significantly improved returns without also assuming unacceptable risks to the asset base of the Plan"
- Assuming an "aggressive approach substantially increases the chances of the catastrophic event of depleting all the assets in the near future"

See Companion Memo, at 21-24. After this plunge – *i.e.,* a roll of the dice putting 10% of the KRS Funds (its largest one-time investment ever) into the black box fund

[14] The HFS' hedge fund products carried "a significant degree of risk" due to, *inter alia*, the lack of any prior track record of performance, lack of objective valuation calculation criteria, use of leverage and short selling resulting in a "***high degree of business and financial risk***" and a "***risk of loss investors should be prepared to bear***." Worse yet, in the case of the Black Box type of hedge funds the HFS sold to KRS and that are at issue here, the HFS admitted "***these risks are exacerbated for our funds of hedge funds***." *See* Companion Memo, at 35.

of hedge funds vehicles with no prior track record of performance – they (1) earned less than KRS' cash in the bank had historically earned (3.75% vs. 3.769%); (2) lost $100 million in 2015-2016, helping tip KRS over the edge toward insolvency; (3) consumed hundreds of millions in fees which have still never been fully totaled up; and (4) were a substantial factor in causing the very "catastrophic event" Defendants had been warned would occur if they took such an aggressive high/risky investment plunge. As a result, KRS' underfunded status has soared by billions, leaving it gravely impaired, requiring at least $800 million more in annual taxpayer contributions – likely in perpetuity – to keep the KRS Funds afloat.

For the fiduciary HFS, who pocketed ***hundreds of millions of dollars in fees*** amidst this debacle, this will be impossible conduct to defend under the applicable and pleaded Kentucky common law fiduciary duty standards.

IV. ATTEMPTS TO DISMISS THE FAC BASED ON UNPLEADED DOCUMENTS OF DUBIOUS LEGALITY OR TECHNICAL GROUNDS SHOULD BE REJECTED

Substantial public policy considerations surround this case involving, as it does, billions in Kentucky citizens' taxpayer dollars and the life savings of hundreds of thousands of its workers. KRS is functionally a unit of the Commonwealth – the sovereign. The HFS were fiduciaries to KRS – the unit of the sovereign to whose Trustees the sovereign's tax dollars and its workers' savings were entrusted ***under Kentucky law*** to be held, overseen, protected and safeguarded. Taking advantage of KRS or its Trustees is fleecing the sovereign.

Every proper possible consideration should be extended to the "sovereign" in this litigation where the public policy implications are so

powerful. *See* T. L. Anenson*, Public Pensions and Fiduciary Law: A View From Equity,* 50 U. Mich. J. L. Reform 251 (2016) (explaining that public pension funds are so exposed to being exploited and abused by "professional" advisers and securities salespeople that they must – ***because of their tremendous public importance – be afforded the fullest protection possible by courts***).[15]

CONCLUSION

When the events alleged in Plaintiffs' FAC occurred, KRS was under the control of incompetent, defaulting Trustees, working without adequately trained or experienced staff support, guided by complicit advisers. It is ***not*** KRS' fault (nor the fault of its members, beneficiaries or Kentucky's taxpayers) that KRS was so ill-served by its Trustees and staff or taken advantage of by its advisors and the HFS – who were jointly paid millions to protect and deal fairly with KRS. KRS could not protect itself then. Now, freed of the domination and control of the wrongdoers, it can.

Dismissal of otherwise well-pleaded Kentucky fiduciary duty claims at the pleading stage based on liability-limiting clauses in agreements extrinsic to the record, which are themselves void or unenforceable under federal and/or Kentucky law, is utterly inconsistent with the policy of properly protecting – and fully

[15] The derivative claim on behalf of KRS is an equitable proceeding. A derivative action is an equitable action given the court its full powers of equity in a proceeding providing plaintiffs with a jury trial. *See* Thomas E. Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KY L.J. Online 31 (2015), *available at* http://www.kentuckylawjournal.org/index.php/2015/04/22/who-will-watch-the-watchers/.

assuring the vigorous assertion of the legal rights of – Kentucky's 350,000-plus member public employee pension fund, who deserve all the proper protections of this Court of Equity.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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