COMMONWEALTH OF KENTUCKY
COUNTY OF FRANKLIN CIRCUIT COURT
DIVISION I
CASE NO. 17-CI-1348

JEFFREY C. MAYBERRY, *et al.* PLAINTIFFS

REPLY MEMORANDUM IN RESPONSE TO KRS'S AND OAG'S OPPOSITION TO, AND IN FURTHER SUPPORT OF, THE TIER 3 PLAINTIFFS' MOTION TO INTERVENE

KKR & CO., L.P., *et al.* DEFENDANTS

ELECTRONICALLY FILED

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The Tier 3 Plaintiffs respectfully submit this response to the opposition briefs filed by, respectively, the Office of the Attorney General ("OAG") and Kentucky Retirement Systems ("KRS").

I. PRELIMINARY STATEMENT

The Tier 3 Plaintiffs note at the outset that the OAG and KRS management express completely different — in many ways diametrically opposed — views as to the current status and "ownership" of the claims made on behalf of KRS.[1] The OAG says it is in complete control of the case, including the KRS claims, having "occupied the field" and assumed "full control" of all claims, based on the "broad authority" and "supremacy" asserted by the Attorney General. KRS management, on the other hand, asserts that the Tier 3 Plaintiffs' Motion to Intervene is premature because it has hired an outside law firm (on a $1.2 million contract) to "investigate the allegations contained in the proposed intervening complaint … and will rely on the results of that investigation in choosing a path forward."[2] In sum, the OAG asserts that it has in effect stepped into the KRS claims as both client/decision-maker and as counsel, while KRS management, appearing through different counsel, says it doesn't yet know what it will do with these claims.

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[1] To be clear, the only claims the Tier 3 Plaintiffs seek to prosecute are claims on behalf of KRS. The Tier 3 Plaintiffs do not advance any "taxpayer" claims.

[2] KRS also argues that the Tier 3 Plaintiffs were obligated to, but did not, make a demand on KRS – even though KRS had previously endorsed substantially the same claims when advanced by the Mayberry plaintiffs on a derivative basis, agreeing after a prior investigation that the claims had merit but would be too expensive and risky for KRS to pursue on its own. KRS also opposes on grounds that the Tier 3 Plaintiffs did not show that such a demand would have been futile (even while running through a litany of reasons it would have rejected any such demand). But — with one exception discussed below — these are exactly the same claims, brought on behalf of the same victim (KRS), as before, only now with representative plaintiffs who meet a legal test that did not exist when the claims were first brought.

The one thing the OAG and KRS management seem to agree on is they don't want people who have actually been injured — and who have no political or other reasons to pull their punches — aggressively litigating this case on the merits.[3]

II. ARGUMENT

A. KRS and the Commonwealth Are Not One and the Same

The principal thrust of the OAG's argument boils down to its contention that KRS and the Commonwealth are one and the same. This contention, variously expressed, singularly animates the OAG's position. But ***KRS and the Commonwealth are not one and the same***, ***and the OAG completely misses that this case exists in the space they do not have in common***.

KRS is without doubt an agency of the Commonwealth, and in some ways is an "arm, branch, or alter ego of the state." But, that's not all it is. KRS is a retirement system, vested with "the powers and privileges of a corporation."[4] Crucially, KRS assets are "trust funds."[5] The KRS Board is the "trustee" of those trust funds.[6] Each KRS trustee is obligated to act "solely in the interest of the members and beneficiaries" and "for the exclusive purpose of providing benefits to members and beneficiaries and paying

[3] And neither of them wants to even acknowledge, much less pursue, the allegations surrounding KKR/Prisma's unlawful self-dealing with KRS trust assets, sponsored and encouraged by KRS management via the secret "Advisory Services Agreement" that purported to allow KKR/Prisma to use KRS trust assets to advance their own business interests. More will be said about this sordid episode below as it is one reason neither the OAG or KRS management is able adequately to protect the interests of the Tier 3 Plaintiffs.

[4] KRS §§ 61.515(1), 61.645(2).

[5] KRS § 61.515(2).

[6] KRS § 61.650(1)(a).

reasonable expenses of administering the system."[7] The OAG's unequivocal assertion that "I'm in charge here" fails on many levels, but toward the top of the list is the failure to recognize or reckon with how these trust fund issues, and the duties that follow therefrom, alter the taxonomy of the beast. While the Attorney General asserts broad power to act in the "interest of the people generally," this case primarily involves trust funds in which the "people generally" have no direct interest and in which KRS members/beneficiaries in general, and Tier 3 members in particular, have substantial interests that do not align with those of the Commonwealth as a whole, and in some important ways are in conflict.[8]

Does the OAG propose that it step in as a sort of super-trustee, displacing the KRS Board in that role — and if so, where in the common law does that power come from? The people-as-king analogy is of little utility when the corpus is a trust that the king may not invade. So, it's difficult, we would say impossible, to conceive of the OAG wearing the KRS client "hat" in this situation. Among other things, the OAG is in no position to carry out the "sole benefit" or "exclusive purpose" duties owed specifically to members/beneficiaries, when (as it proudly proclaims) its "fealty is to [all] the people of the Commonwealth." The specific conflicts we have previously mentioned ineluctably follow from this fundamental dichotomy.

KRS management makes clear in its own brief that it is awaiting the results of a secret, non-public investigation (a curious step since it conducted a prior investigation that led to the Joint Notice) before making its next move. But clearly, the KRS Board has

[7] KRS § 61.650(1)(c).

[8] We have pointed out in some detail the different, conflicting interests at play, but the OAG utterly fails to address, much less even attempt to solve, these conflicts. *See* Appendix 1 hereto for detail regarding the OAG's conflicts.

not retained the OAG as counsel for KRS — nor has it abdicated its trusteeship in favor of the OAG. The OAG has not appeared in this case on behalf of KRS. The record in fact speaks to the contrary; the OAG moved to intervene only as "the Commonwealth," and it in fact stripped KRS's damages out of the Intervening Complaint when it copied the original *Mayberry* Plaintiffs' work product.

Defendants previously argued that KRS members have no standing because only the OAG can litigate the claims on behalf of KRS. But the Attorney General has not had exclusive authority to represent Kentucky agencies since 1948.[9]

KRS has an extraordinary level of autonomy not afforded to the vast majority of public entities in Kentucky — the Board of KRS has "the powers and privileges of a corporation, including but not limited to the … power [t]o sue and be sued in its corporate name." KRS § 61.645(2). Only KRS, and one other public entity (also an employee benefits entity, the Kentucky Public Employees Deferred Compensation System, as per KRS § 18A.235) have this prerogative. KRS does not need a note from the Governor, or approval of the Attorney General, to retain counsel and litigate. KRS is a frequent litigant in this Court, as reflected by dozens of cases on the Court's docket, and is rarely, if ever, represented by the Attorney General.

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[9] Defendants would be right if the enactment of KRS § 12.210 in 1948 had not repealed the former KRS § 15.050, which provided that:

> No state officer or agency shall employ or be represented by an attorney ***other than the Attorney General*** unless an emergency arises which, in the opinion of the Attorney General, requires the employment of other or additional counsel to protect the interest of the Commonwealth, or a litigation arises in which the Attorney General has an adverse interest. In either event the Attorney General shall in writing set forth the reasons for the employment, and request the Governor to employ other or additional counsel. KRS § 15.050 (repealed) (emphases added).

B. The OAG Does Not Adequately Represent the Interests of the Tier 3 Members

Tier 3 members, unlike other KRS members, participate in a "hybrid cash balance plan" which has some features like defined benefit plans and others like defined contribution plans. All plan assets are held in a common pool; there are no segregated cash accounts set aside for Tier 3 (or other) KRS members. This feature means that ***any damages or equitable recovery must go to the KRS asset pool, not directly to any member's account***. The Tier 3 members, unlike other KRS members, are entitled to "Upside Sharing Interest" credits to their accounts, based on an allocation of plan-wide net return over rolling five-year periods. This feature means that ***the recovery must be on a plan-wide basis***, with damages allocated to individual plan years so that each rolling five-year average can be recalculated, and so that the plan remains solvent and able to ultimately pay Tier 3 benefits.

The OAG does not seem to understand precisely how the Tier 3 members are situated, or what distinguishes their interests from the Tier 1 and Tier 2 members (or from "the people generally"). Perhaps as a result, the OAG simply does not respond to our argument that it does not and cannot adequately represent the legitimate and substantial interests of the Tier 3 members. The OAG does not suggest how it would address the unique interests of the Tier 3 members, nor does it even attempt to deal with the conflicts we have previously raised.

Nor does the OAG sketch out a plan to address the tremendous imbalance in resources available to, respectively, the OAG and defendants. The resource constraints under which the OAG labors — largely, but not only, flowing from the procurement statutes — will leave it unable to stand toe-to-toe with these well-funded defendants and

thus hard-pressed to achieve an optimal settlement when the Wall Street defendants turn on the scorched-earth machine.[10] While the OAG and defendants continue to suggest that those same procurement statutes should prevent privately retained derivative counsels' participation in the case, no one has articulated how private counsel, retained by private derivative plaintiffs (not any governmental entity), fall within such statutes.[11]

The OAG's statement that "the Tier 3 Group cannot intervene just by adding a cost-of-living-adjustment (COLA) claim" is nonsensical — and illustrates how little the OAG understands the intricacies of this case. The longer-tenured Tier 1 and 2 members lost their COLAs in or about 2011, well before Tier 3 was created in 2014. Tier 3 members never had a COLA. But Tier 3 members did and do have a right to "Upside Sharing Interest" — an annual increase in the amount credited to each member's individual account if that member's system (*e.g.*, KERS) had, at the end of a given fiscal year, a geometric average net investment return in excess of 4% for the prior five years.[12] In other words, each Tier 3 member's account balances fluctuate based on net investment return. Reduced system-wide returns resulting from the conduct alleged in the Intervening Complaint have caused (and, because of the long-term effects of compounding) continue

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[10] We have previously mentioned the political constraints as well. Rather than responding with assurances that the Attorney General will tenaciously pursue the case without fear or favor despite the oversized presence at the defense table of one of the 5 largest Republican donors in the country, the OAG's reaction to our having pointed out the obvious is to suggest that even mentioning the elephant in the room was unworthy. The fact is — the heat goes with the kitchen.

[11] As in all derivative litigation, the Court must finally approve our fees; that is the oversight mechanism. But the defense suggestion is like permitting the officers and directors of a nominal defendant company in private derivative litigation to dictate the fees of plaintiff derivative counsel.

[12] Among other things, the huge, excessive fees charged by the hedge funds, discussed in the Motion for Accounting filed by the Tier 3 Plaintiffs, materially diminished net investment return.

to cause injury to the Tier 3 Plaintiffs and to all Tier 3 members. ***These injuries will only be remedied by plan-wide damages that can be attributed to individual plan years***, leading to additional amounts being credited to Tier 3 members' accounts redressing their injuries, along with all other plan members. But the OAG shows no interest in pursuing this kind of recovery — perhaps because the interest of "the people generally" is in recovery to the Commonwealth (*i.e.*, funds to be deposited in the state treasury as opposed to the KRS trust funds).[13]

C. The OAG's Other Arguments Do Not Require Denial of Intervention

We respond summarily to the OAG's other arguments, as follows:

First, the OAG misreads *Overstreet v. Mayberry*, 603 S.W.3d 244 (Ky. 2020). The Supreme Court expressly limited its opinion to the issue of constitutional standing; it did not address or decide whether KRS members with constitutional standing could bring these claims under statutory, common law or trust law theories. (This Court, of course, has previously ruled in favor of such standing.) And the Supreme Court's comments about the role of the Attorney General in this case were limited to that section of the opinion dealing with the *Mayberry* Plaintiffs' "taxpayer" claims (*i.e.*, their "claims on behalf of the Commonwealth") — not their derivative claims on behalf of KRS. *Id.* at 265. Indeed, the Supreme Court did not mention the Attorney General except in relation to the taxpayer claims. *Id.* The Supreme Court did not hold, as the OAG suggests, that "there is no right in Kentucky for a private person to litigate a case on behalf of a state agency such as the Kentucky Retirement Systems."[14] *See* OAG's Br. at 11. To the contrary, and as

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[13] Another argument raised that the OAG fails to address.

[14] It is noteworthy that the bi-partisan leaders of both houses of the legislature disagree with the OAG's conclusion. They told the Supreme Court in their *amicus* brief that they understood, and assumed in their legislative process, exactly the opposite — that

argued in greater detail in our companion Reply to Defendants filed herewith, the Supreme Court specifically reserved ruling on the standing of the Tier 3 Plaintiffs to assert the claims arising from what it recognized as "significant misconduct."

Second, the OAG reads too much into the language it cites from *Merck Sharp & Dohme Corp. v. Conway*, 947 F. Supp. 2d 733 (E.D. Ky. 2013). There, the Court alluded to the Attorney General's right to "full control" over his own retained counsel — not some larger concept of domination over any case the OAG might happen to become involved in on the same side as other parties.

Third, the OAG's suggestion that derivative cases may be brought only where the legislature has specifically provided for them is just wrong. We extensively briefed this issue to this Court before it ruled on the Motion to Dismiss.[15] The *amicus* brief filed in the Supreme Court by the bi-partisan leaders of both houses of the legislature confirmed in an extraordinarily direct fashion the legislative understanding that derivative actions on behalf of KRS are available under common law. We also cover this issue in our Reply to Defendants' identical arguments, filed herewith, pointing out that plaintiffs could sue under common law and trust law, and that ERISA authorities unanimously held no pre-suit demand is required of plan members suing for the plan under a statutory authorization — here KRS § 61.645 — that does not contain a demand requirement. As this Court ruled, a § 61.645 action is not a classic corporate "derivative" action.

Kentucky common law has always and still does recognize the existence of derivative suits in connection with KRS. *See* Ex. A to the Tier 3 Plaintiffs' Feb. 1, 2021 Br. at 9-10.

[15] We attach as Appendix 2 our prior briefing (the Mayberry plaintiffs' September 11, 2018 Response to PRISMA/PAAMCO Defendants' Post-Hearing Submission) on this exact same issue; there is no need for us to re-brief these points, or for the Court to expend judicial resources on these re-runs.

D. KRS Management Is Conflicted

KRS makes four basic points in its opposition brief:

- that the Tier 3 Plaintiffs failed to make a new demand;
- that the Tier 3 Plaintiffs failed to plead demand futility;
- that intervention is premature as KRS is investigating the allegations; and
- that the April 2018 Joint Notice "is no longer operable."[16]

The four actually boil down to one: KRS management doesn't relish a vigorous, unimpeded prosecution of the claims it cannot control.[17]

KRS and the OAG suggest that we are beyond the pale in our discussion of various conflicts. But, they don't actually refute the conflicts, and facts are pesky things.

Certain members of current and former KRS senior management — most particularly current Executive Director David Eager, who presumably is managing the $1.2 million investigation, and former Chief Investment Officer David Peden — committed serious breaches of duty as a result of conflicts of interest. One (but not the only) such conflict involved the wrongful conduct of these officials in essentially privatizing the management of KRS's $1.6 billion hedge fund portfolio — placing management of the entire portfolio in the hands of a very self-interested KKR Prisma, effectively acting as inside director of hedge funds, without supervision by anyone other than Peden, himself a former Prisma employee — and ***expressly permitting KKR Prisma to self-deal with KRS trust assets in lieu of other payment for these***

[16] It appears the word intended was "operative," as famously employed by Ron Ziegler many years ago.

[17] Moreover, this Court has previously rejected these same demand arguments. *See* detailed discussion of this point in the companion Reply to Defendants' identical arguments.

"***advisory services***." The "Advisory Services Agreement" that documented this unlawful relationship expressly stated that the "consideration" for KKR Prisma's work inside KRS (which included vetting other hedge funds for possible investment by KRS) would include "***the opportunity for*** [***KKR Prisma***] to expand its industry knowledge and ***develop further business relationships with third parties through the provision of services under this Agreement***." In other words, KKR Prisma was put in the position of selecting (or declining to select) other hedge funds in which KRS would invest hundreds of millions of trust fund dollars — and "in consideration" ***KKR Prisma was permitted to use this "gatekeeper" position to get access to other hedge funds' secret information, and otherwise use the position to "further develop*** [***its own***] ***business relationships***," ***i.e.***, ***to leverage KRS assets for its own unaccountable but doubtless highly lucrative benefit***. We attach as Appendix 3 the detailed and specific allegations concerning this sordid episode. CIO Peden, the former Prisma employee, was the principal driving force inside KRS at the outset. Mr. Eager, when he was a trustee, moved and voted for the final pay-off (an additional $300 million invested in Prisma's Daniel Boone vehicle, despite Prisma having been the worst-performing of the three original Black Boxes) but also, ***as Executive Director***, ***permitted the unsupervised self-dealing to continue in secret and did nothing to red-flag or stop it***.

This situation pervades KRS's new $1.2 million "investigation." And, truth be told, much of the friction between KRS and this legal team can be traced to our development of these allegations — taking the case where the facts led — and KRS's months-long attempt to slow or stymie the development or public disclosure of this story. In any event, we urge the Court to review the allegations contained in Appendix 3 (straight out of the

Tier 3 Plaintiffs' proposed Verified Complaint in Intervention, but first known to KRS management by February 2019, and made public through the Mayberry Five's motion for leave to amend filed while the case was on appeal on September 6, 2019).[18]

III. CONCLUSION

For the reasons set forth above and in the Tier 3 Plaintiffs' December 31, 2020 motion to amend (held in abeyance but still pending) and their February 1, 2021 Motion to Intervene, the Court should permit them to intervene in this action.

Dated: March 8, 2021

Respectfully submitted,

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[18] We also note in this context that the OAG has not pleaded or even so much as mentioned these allegations, even though they deal with a third party actually "taking control" of KRS trust assets, and even though the plain facts suggest at least the possibility of kick-backs or other criminal activity.

CERTIFICATE OF SERVICE

The above signature certifies that, on March 8, 2021, the foregoing was served via email in accordance with any notice of electronic service or, in the absence of an electronic notification address, via email or mail as indicated below, to:

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Appendix 1

Appendix 1

COMMONWEALTH OF KENTUCKY
COUNTY OF FRANKLIN CIRCUIT COURT
CASE NO. 17-CI-1348
DIVISION ONE

JEFFREY C. MAYBERRY, *et al.* PLAINTIFFS

v.

MEMORANDUM IN SUPPORT OF THE TIER 3 PLAINTIFFS' MOTION FOR LEAVE TO FILE A THIRD AMENDED COMPLAINT

KKR & CO., L.P., *et al.* DEFENDANTS

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board, and the board may contract for legal services, notwithstanding the limitations of KRS Chapter 12 or 13B."

There is no indication that the KRS Board has asked the Attorney General to represent it in this matter, and in any event as noted above, the Attorney General would face a difficult if not insoluble conflict of interest in that regard.

The Tier 3 Plaintiffs do not dispute the right of the Attorney General's office to intervene. They would, however, object to any (as yet unarticulated) attempt by the Attorney General's office to take over the prosecution of the derivative claims. KRS's assets — including its legal claims for damages — are separate from the Commonwealth and belong to KRS, not the taxpayers. They are trust funds to be used exclusively for KRS trust purposes. KRS and the Commonwealth have a common interest in creating as big a pot as possible but a conflicting interest as to how to divide that pot. And they have many other potential conflicts as well.[19]

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[19] The chart below outlines some of these different, conflicting interests.

Commonwealth	KRS
Primary interests are future funding and protection of the Commonwealth in connection with potential payments under the inviolable contract protections.	Primary interests are recovering damages including losses in and for past years.
Recovery goes to the State Treasury, specifically, the "general fund surplus account," under KRS § 48.005 (4).	Recovery goes to (and should be appropriately split among) the KRS trust accounts, including the insurance trust(s). *See* KRS §§ 61.515, 61.570, 61.701. This result flows from the "use or be sued" language in KRS § 61.645(2)(a). (Commonwealth's interests — because of the inviolable contract issues — would be in all recoveries going toward pension trust funding, directly or indirectly, not to

There is one more point to be made, and it is a sensitive one. This case is high-profile, with many eyes on it. The process and result must be respected as honest and above-board. The appearance of impropriety must be guarded against. Some of the wealthy defendants are among the largest donors to Republican causes and candidates in the country. Defendant Stephen A. Schwarzman in particular has donated tens of millions of dollars during the 2019–20 cycle, including at least $35 million to the McConnell-related Senate Leadership Fund, and very possibly to "dark money" groups. The *Lexington Herald-Leader* reported on May 6, 2019:

> An independent "dark money" group from Washington reports spending $350,000 to influence the May 21 Republican primary in

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	insurance trusts — and not to past year accounts to benefit the Tier 3 members.)
Commonwealth's interests are different than both Tier 3 members, and of Tier 1 and 2 members.	Tier 3 members have an interest in adding to past years' excess pension fund returns, to increase their sharing interests, and to insurance trust. Tier 1 and 2 interests do not conflict with these interests, but Commonwealth's interests do.
Attorney General is not the attorney for KRS unless the KRS Board requests that the Attorney General represent KRS. KRS § 61.645 (11).	Attorney General may act as attorney for the board, but the board can also contract for outside legal services (so the Attorney General is not the exclusive attorney for KRS). KRS § 61.645 (11).
Intervening Complaint ¶ 1: "damages for losses incurred ***by the Commonwealth*** ...."	*Mayberry* FAC ¶ 1: "damages for the losses incurred ***by KRS*** ...."
Intervening Complaint, Prayer ¶ 2: "Determining and awarding the ***Commonwealth of Kentucky*** the compensatory damages sustained as a result of the violations set forth above ...."	*Mayberry* FAC, Prayer ¶ 4: "Determining and awarding to ***KRS and its Pension Funds and the Commonwealth of Kentucky*** the damages sustained by them as a result of the violations set forth above ...."

> Kentucky's attorney general race — more money than either candidate has in his own campaign.
>
> The Judicial Crisis Network is promoting Daniel Cameron, former legal counsel to U.S. Senate Republican Leader Mitch McConnell of Kentucky, in his contest against state Sen. Wil Schroder of Wilder.

John Cheves, *'Dark Money' Group Spending Big for McConnell Protégé in KY Attorney General Primary*, LEXINGTON HERALD-LEADER, May 6, 2019.

We do not at this point know whether Mr. Schwarzman or any of the other defendants were involved, and we make no such accusation other than to note the possibility of a conflict, or the appearance of a conflict, of a political nature in the event of settlement or dismissal of claims by the Attorney General — a problem that would be ameliorated, if not entirely avoided, through the co-prosecution of these claims, as we have previously suggested.

III. CONCLUSION

For the reasons set forth above, in the proposed TAC and in Exhibits A and B, the Tier 3 Plaintiffs respectfully urge the Court to grant their motion for leave to amend, to order the TAC filed, and for such other or further relief as may be appropriate.

Dated: December 31, 2020

Respectfully submitted,

s/ Michelle Ciccarelli Lerach

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Appendix 2

Appendix 2

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COMMONWEALTH OF KENTUCKY
COUNTY OF FRANKLIN CIRCUIT COURT
CASE NO. 17-CI-1348

DIVISION ONE

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

v.

PLAINTIFFS' RESPONSE TO PRISMA/PAAMCO DEFENDANTS' POST-HEARING SUBMISSION

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

ELECTRONICALLY FILED

* * * * * * * *

Plaintiffs Jeffrey C. Mayberry, *et al.* respectfully submit this response to Defendants Post-Hearing Submission ("PHS").

1. Standing

The standing arguments raised by Prisma/PAAMCO are neither well taken nor dispositive. Their conclusions about KRS 61.645(15)(f) are simply wrong. They entirely ignore Plaintiffs' other derivative standing arguments. And their argument about taxpayer standing is nonsensical.

Prisma/PAAMCO asserts that *only* the KRS Board – and not an individual suing on a derivative basis – may sue on behalf of KRS. PHS at 1. But ***the language of the statute itself defeats that argument and affirmatively supports derivative standing.***

KRS 61.645(15)(f) refers to a "*person* bringing an action for monetary damages ... *suffered by the Kentucky Retirement Systems*." (Emphasis added.) The

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term "person" is defined as a "natural person." KRS 61.510(30). The Board is not a "person." Thus ***KRS 61.645(15)(f) contemplates one or more individuals suing derivatively on behalf of KRS***.

The Legislature did not *create* derivative standing when it enacted KRS 61.645; rather, it *assumed* that a "person" (not just the Board) could bring an action for harm suffered by KRS – in other words, bring a derivative action – and fashioned special burden of proof rules for cases against trustees that would be *surplusage* if no "person" could sue on behalf of KRS.[1] "It is a rule of statutory construction that a statute should be construed so that no part of it is meaningless or ineffectual. *Gen. Motors Corp. v. Book Chevrolet, Inc.*, 979 S.W.2d 918, 919 (Ky. 1998)." Defendants' interpretation would render KRS 61.645(15)(f) meaningless or ineffectual; it would have no place or meaning if only the Board could sue on behalf of KRS.

No statutory basis or other principled reason exists for limiting derivative cases on behalf of KRS to claims under KRS 61.645. The structure of the Pension Law [KRS 61.510 *et seq.*] supports the view that derivative actions may be brought. The Pension Law provides that trustees, officers, employees and other fiduciaries have fiduciary duties; that such duties are to be exercised "[s]olely in the interest of the members and beneficiaries;" and that the Board has the right to "sue or be sued"

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[1] That the Legislature would assume that a person could bring a derivative suit on behalf of KRS is unsurprising. "[C]ourts have repeatedly recognized derivative suits in the absence of express statutory authorization." *Tzolis v. Wolff*, 10 N.Y.3d 100, 106 (2008). "The derivative suit ... was not created by statute, but by case law." *Id.* at 103.

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– and it recognizes that the Board's right to sue is not exclusive, and that one or more individuals may bring an action for the benefit of KRS.[2]

The mere absence of a statute governing *procedure* in derivative cases on behalf of KRS is not the same as legislative prohibition of such cases. *See generally*, Thomas E. Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KY. L.J. ONLINE 31 ("[T]he ability to enforce fiduciary obligations has its basis in equity rather than in positive statutory law.") The argument that the Legislature intended to prohibit derivative suits on behalf of KRS has no objective basis; indeed, the statutory language discussed above forecloses that argument.

The unpublished opinion in *Porter v. Shelbyville Cemetery Co.*, 2009 WL 722995 (Ky. App. 2009) does not "foreclose" anything. *See* CR 76.28(4)(c). Nor is it persuasive, for the reasons set out in *Who Will Watch the Watchers?* [*see* pp. 43-44] and additionally because the plaintiffs in that case lacked the kind of stake in the outcome that underpins standing generally. Barbara Porter "was never a member of the corporation because of her failure to own a burial plot" and she therefore "lacked

---

[2] *See*, KRS 61.650(1)(c), 61.645(2)(a), and 61.645(15)(f). The fact that the Legislature made explicit mention of "persons" suing to recover on behalf of KRS only in connection with suits against trustees does not in any way suggest that derivative suits are not available against officers, directors, other fiduciaries, or other persons. The language in KRS 61.645(15)(f) represents a change from the ordinary burden of proof and related rules and was necessary for that reason; suits by KRS (directly or derivatively) against officers, directors, other fiduciaries, or other persons are not governed by a heightened burden of proof, and non-trustees are not entitled to the extraordinary protections set out in KRS 61.645(15), so there was no need to specify in the legislation that the normal rules apply.

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a judicially recognizable interest sufficient to invoke the court's jurisdiction" and was a "legal stranger[] to the corporation." *Id.* at *3. "[I]n order to have standing in a lawsuit a party must have a judicially recognizable interest in the subject matter of the suit." *HealthAmerica Corp. of Kentucky v. Humana Health Plan, Inc.*, 697 S.W.2d 946, 947 (Ky. 1985).[3]

The language of KRS 61.645(15)(f) supports Plaintiffs' standing, at least with respect to their equitable claims for Breach of Trust against trustee defendants and those who aided and abetted them. In view of the Legislature's assumption that a "person" with a "a judicially recognizable interest" *can* sue on behalf of KRS, Defendants' other derivative standing arguments must fail.

After nearly 3 hours of argument, Defendants only briefly touched on taxpayer standing in their reply arguments. The nonsensical argument contained in their proffered Post-Hearing Submission, suggesting some kind of improper "delegation," only confirms that they have no persuasive argument on the point.

2. Statute of Limitations

Defendants assert (again) that Plaintiffs' claims are time-barred and not tolled. Plaintiffs ask the Court not to take as a given any representation by

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[3] The remaining arguments directed at KRS 61.645 deserve little attention. The *Fort Wright* matter was brought as a direct (class) action, not as a derivative suit. KRS did not address derivative standing in its brief in that case, nor would it matter if it did. Defendants completely mischaracterize the issues and holding in *Jones v. Board of Trustees of Kentucky Retirement Systems,* 910 S.W.2d 713 (Ky. 1995), which was a declaratory judgment case brought by the Board against the Governor and other state officials, involving legislative funding levels.

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Defendants that Plaintiffs "concede" or "acknowledge" anything, as they are rarely right in that regard. When Plaintiffs believe their position is clear, neither words nor space will be wasted in refuting every such erroneous characterization.

Defendants do not even attempt to deal with the continuing duty doctrine, or show how claims based on breaches of duty that took place within five years of filing can be time-barred, even if the base limitations period were five years (which it is not).[4] As explained in *Tibble v. Edison International,* 135 S. Ct. 1823, 1828-9 (2015), such claims accrue each time the continuing duty is breached, not when prior investment decisions may have been made.[5] The claims here include claims for breach of continuing duties, including against the Hedge Fund Sellers, well within any statute of limitations.

Nor do these Defendants explain how KKR/Prisma (and associated defendants) avoid on limitations grounds claims involving the KRS' mid-2016 purchase of an additional $300 million of the KKR/Prisma Daniel Boone Fund, a purchase made while a Prisma employee, still on the Prisma payroll, was working inside KRS on hedge fund issues, and at a time when an admitted fiduciary relationship existed between Prisma and KRS, and after the Daniel Boone Fund had just posted an 8% loss for the prior fiscal year. *See* FAC ¶¶ 87-91, 199-202;

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[4] Plaintiffs stand on their prior briefing and argument in support of the application of the ten-year statute of limitations allowed by KRS 413.160, and also point out all defendants' failure to explain how cases that don't even address that statute stand as authority against its application here.

[5] The continuing duty doctrine is not a tolling doctrine and does not depend on tolling.

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Oppo. at pp. 22-23; Pls. Visuals 11, 12, and 33 (respectively, "2016 KKR/Prisma $300 Million Sale," "KKR/Prisma/PAAMCO 2016 $300 Million Black Box Self-Dealing Transaction," and "Dates and Duties").[6]

Defendants' argument that adverse domination cannot toll limitations in fiduciary duty cases relies on this bit of circular reasoning: since (they say) the discovery rule had not previously been applied in fiduciary duty cases, the Supreme Court could not have intended its decision in *Wilson v. Paine*[7] (adopting adverse domination, which it called a "corollary" of the discovery rule) to apply in fiduciary duty cases. They are wrong. Adverse domination is triggered by the directors' breach of fiduciary duty. The reasoning and language of *Wilson v. Paine*, and its heavy reliance on fiduciary duty cases in other jurisdictions, bely the suggestion that the Court intended to exclude fiduciary duty cases from the ambit of the adverse domination rule. Adverse domination tolling is in play here; ultimately its application will flow from facts as found by the jury.

Defendants offer three more weak arguments in their attempt to escape adverse domination tolling. First, they observe that adverse domination is a corporate doctrine and Plaintiffs are individuals. But Plaintiffs are suing in a representative capacity on behalf of KRS. Second, they suggest that adverse domination is not available if potential derivative plaintiffs – outside shareholders typically – may have knowledge that might trigger limitations in other

[6] In the event Prisma/PAAMCO is permitted to file its post-hearing submission, Plaintiffs request leave to file a response to that submission.

[7] 288 S.W.3d 284 (Ky. 2010).

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circumstances. But this argument runs counter to the "disinterested majority" rule adopted in Kentucky; the potential existence of a dissenting director or shareholder with knowledge does not destroy tolling because such a person has neither the *power* to force the corporation to sue, or the *duty* to pursue the suit on behalf of the corporation in a derivative action. "[W]here, as here, the management of a corporation's affairs are de facto under the domination and control of the adversary of such cause of action, or the corporation is de facto powerless to sue on such cause of action because of the lack of a disinterested majority of its board, mere notice to shareholders does not start running of limitations against the corporate cause of action." *Allen v. Wilkerson*, 396 S.W.2d 493, 502 (Tex. Civ. App. Austin, 1965).[8] Finally, Defendants argue that adverse domination cannot toll claims against third parties. While *Wilson v. Paine* did not reach this issue, the Court telegraphed its intention to include such claims by citing and placing significant reliance on at least three cases in which claims against third parties *were* tolled under the adverse domination rule: *RTC v. Gardner*, 798 F.Supp. 790 (D.D.C. 1992); *RTC v. Farmer*, 865 F.Supp. 1143 (E.D. Pa. 1996); and *Clark v. Milam*, 192 W.Va. 398 (W.Va. 1994). *Gardner*, in fact, was only against a third party.

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[8] The *Allen* case, and subsequently the Fifth Circuit in *FDIC v. Dawson*, 4 F.3d 1303, 1310 (5th Cir. 1993) also put to rest any assertion that a plaintiff need sue all culpable directors in order to invoke adverse domination tolling. ("The issue most hotly contested by the parties is whether a plaintiff seeking to toll the statute of limitations under the adverse domination doctrine must sue all allegedly culpable directors. ... *Allen* thus plainly demonstrates that a plaintiff may sue only a minority of the board and still assert adverse domination to toll the statute of limitations under Texas law.") Plaintiffs need only prove at trial that a majority was culpable.

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In *Fluke v. LeMaster*, 306 S.W.2d 55 (Ky. 2010), the Supreme Court acknowledged that the doctrine of equitable estoppel is *not* limited to "statutory estoppel" under KRS 413.190, but that a common law variant of equitable estoppel tolling is also recognized in Kentucky, even against non-residents.[9] Despite the unavailability of KRS 413.190 because of the defendant's non-resident status, the Supreme Court recited six fact-bound factors governing equitable estoppel. While the facts in *Fluke* did not ultimately support estoppel at the summary judgment stage, the facts here have yet to be developed and cannot be decided on the Rule 12 motion.[10]

Finally, Defendants assert, as if it were written in stone, the unavailability of the discovery rule in a fiduciary case. Defendants' basic premise is incorrect. The essence of the discovery rule is alive and well in Kentucky fiduciary duty cases; it just goes under different names, such as equitable estoppel or "continuous representation."[11] Kentucky does *not* generally permit faithless fiduciaries (resident or not) to breach their duties to Kentucky workers and retirees, then escape liability

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[9] Footnote 9 of the *Fluke* opinion makes clear that the Court was considering the contours of equitable tolling against non-residents: "Statutory estoppel [under KRS 413.190] clearly does not apply here since Fluke is not a resident of Kentucky."

[10] Defendants mention a diligence requirement that does not exist under Kentucky law in the context of fiduciary relationships. *See, Security Trust Co. v. Wilson,* 210 S.W.2d 336, 338 (Ky. 1948).

[11] The Supreme Court created the continuous representation rule in *Alagia, Day, Trautwein & Smith v. Broadbent*, 882 S.W.3d 121, 124 (Ky. 1994). Responding to the "plea" of the appellate court that the "facts in this case ... illustrate the compelling need for further protection for the unwary and unsophisticated than may be afforded by the discovery rule," the Supreme Court approved the "continuing representation rule."

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by hiding the facts from those to whom duties are owed. That would offend the thrust and direction of Kentucky jurisprudence, as articulated by the Supreme Court:

> While this Court has faithfully observed legislative mandates by which claims not brought in the time required are held to be barred, we have shown no reluctance to construe such statutes in a manner which prevents parties from profiting by their own machinations. We have acknowledged the value of statutes which bar stale claims arising out of transactions or occurrences in the distant past, despite their arguable conflict with various sections of the Constitution of Kentucky, but carved out exceptions, foremost among them being estoppel or some facet thereof, to prevent fraud or inequity. Such was the holding in *Munday v. Mayfair Diagnostic Laboratory*, Ky., 831 S.W.2d 912 (1992), wherein parties required to file a certificate of doing business under an assumed name were denied benefit of the applicable statute of limitation during the period of their noncompliance with the law. The Court reasoned that as the purpose of the assumed name statute was to inform the public of the identity of persons so engaged in business, their failure to comply should be regarded as an obstruction within the meaning of KRS 413.190(2) resulting in an estoppel.

Alagia, Day, Trautwein & Smith v. Broadbent, 882 S.W.3d 121, 124 (Ky. 1994). It is worth observing, for the further application it may have in this case, that the courts of Kentucky, when sitting in equity and hearing equitable claims as these surely are, hold a trustee or fiduciary to liability to its beneficiary or ward under circumstances when a purely arms-length transaction might fare differently.

Further proving the point, and to the same effect – the protection of innocent taxpayers or pensioners is also dear to the courts of equity– *see*, *Rosenbalm v. Commercial Bank of Middlesboro*, 838 S.W.2d 423, 428-29 (Ky. App. 1992). ("We are not prepared to deny the taxpayers of Bell County an opportunity to legally redress a situation directly impacting their pecuniary interest simply because they lacked

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the lawyerly acumen to recognize the possibility of advancing a sophisticated constitutional argument at a time when their pecuniary interest was by all appearances *not* in jeopardy.")

Respectfully submitted,

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Appendix 3

COMMONWEALTH OF KENTUCKY
COUNTY OF FRANKLIN CIRCUIT COURT
CASE NO. 17-CI-1348
DIVISION ONE

JEFFREY C. MAYBERRY,* HON. BRANDY O. BROWN,* MARTHA M. MILLER,* STEVE ROBERTS,* TERESA M. STEWART,* ASHLEY HALL-NAGY, TIA TAYLOR and BOBBY ESTES, Derivatively as Members and Beneficiaries of Trust Funds on Behalf of the KENTUCKY RETIREMENT SYSTEMS, Its Pension Funds and Insurance Trusts
*NOT ASSERTING CLAIMS IN THIS COMPLAINT

PLAINTIFFS

v.

[PROPOSED] VERIFIED COMPLAINT IN INTERVENTION BY "TIER 3" MEMBERS OF THE KENTUCKY RETIREMENT SYSTEMS PLEADING A MEMBER/BENEFICIARY DERIVATIVE ACTION FOR THE KENTUCKY RETIREMENT SYSTEMS AND ITS PENSION PLANS AND TRUST FUNDS

KKR & CO., L.P., HENRY R. KRAVIS, GEORGE R. ROBERTS, PRISMA CAPITAL PARTNERS, L.P., GIRISH REDDY, BLACKSTONE GROUP L.P., BLACKSTONE ALTERANTIVE ASSET MANAGEMENT, L.P., J. TOMILSON HILL, STEPHEN A. SCHWARZMAN, PACIFIC ALTERNATIVE ASSET MANAGEMENT COMPANY, LLC, JANE BUCHAN, R.V. KUHNS & ASSOCIATES, INC., JIM VOYTKO, REBECCA A. GRATSINGER, CAVANAUGH MACDONALD CONSULTING, LLC, THOMAS J. CAVANAUGH, TODD B. GREEN, ALISA BENNETT, ICE MILLER, LLP, WILLIAM S. COOK and DOES 1–20

DEFENDANTS

ADDITIONAL DEFENDANT:

MICHAEL RUDZIK
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KENTUCKY RETIREMENT SYSTEMS

NOMINAL DEFENDANT

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284. If the KRS trustees actually ever read or understood these risks, they were even more willfully reckless to commit $1.2–1.5 billion, which was 10% of the Trust Funds, and all at one time on these fund of hedge funds. The Hedge Fund Sellers should never have sold these products, no matter what "warning" was buried in the paperwork, and the Investment Advisor and Fiduciary Advisor never should have permitted the sale of these products to KRS as they were absolutely unsuitable investments for a pension fund in the particular situation KRS was in, and violated the applicable laws, codes and standards. The true nature and extent of the risk of these so-called "investments" was never disclosed to the KRS members or beneficiaries, or Kentucky taxpayers in any, let alone "easily understood," language, and this failure of disclosure to KRS members and beneficiaries and the Commonwealth, was known to the other Defendants because they received and reviewed KRS's Annual Reports.

C. In 2015–16, KKR, Cook and Rudzik Working with Peden Get Inside KRS, Take over Its Absolute Return Portfolio and Exploit KRS for Their Own Gain

285. The course of misconduct, aiding and abetting, common enterprise and conspiracy that originated in 2008–11, when Defendant Cook (then a senior executive of Prisma) and Peden (then a member of the KRS investment staff) worked together to help engineer the initial Black Box purchases, including the conflicted $400+ million Prisma Daniel Boone Fund, continued in 2015–16 when KKR Prisma's Cook and Michael Rudzik worked in concert with Peden, by then KRS's Chief Investment Officer (CIO), to deliver control over KRS's entire $1.6 billion hedge fund portfolio to KKR — a Wall Street behemoth whose numerous interests conflicted with the interests of KRS and its members — and then allow KKR Prisma and its top executives to leverage that position for their own self-interested benefit, all to the detriment of KRS, its members,

and the taxpayers. This was no random match; Peden had worked for Cook and Rudzik when all three had been employed by Aegon, then Prisma, and they had maintained their close relationship thereafter when Peden went on staff at KRS. The plan these three cooked up was to replace KRS's Director of Absolute Return — the single KRS staff person with direct responsibility for its entire $1.6 billion hedge fund portfolio – with KKR Prisma's own man Rudzik, who would work inside KRS as a quasi-staffer and take charge of the hedge fund portfolio as (in all but name) Director of Absolute Return. The co-conspirators planned to use this effective control to increase KRS's investment in the Prisma Daniel Boone Fund by $300 million, while divesting the other two Black Boxes, BAAM's Henry Clay Fund and PAAMCO's Newport Colonels Fund — even though Prisma's was by far the worst-performing of the three original Black Box funds, trailing the other two by more than 20% since inception. Divesting the other two Black Boxes would free up funds to invest in Daniel Boone and in other hedge funds beholden specifically to KKR Prisma. Finally, with Peden's approval and active assistance, KKR/Prisma/Reddy/Rudzik planned to leverage their position as overseer and gatekeeper of KRS's large and growing direct hedge fund portfolio (a planned $800 million of direct hedge fund investments, including the purchase of hundreds of millions in new hedge fund investments on the conflicted recommendation of KKR Prisma) to their own self-dealing benefit, all without meaningful supervision other than Peden himself.

286. KKR acquired Prisma and its hedge fund business in 2012 after negotiations that began in 2010. KRS's conflicted $400+ million investment in the Prisma Daniel Boone Fund helped "dress up" Prisma for sale to KKR. With KKR's acquisition of Prisma, Cook and Rudzik became managing directors at KKR. They sold

their ownership interests in Prisma to KKR for millions of dollars, most of which was to be paid out over time in contingent performance-based "earnout" payments. The size of these performance-based earnout payments would depend on the growth in revenues and assets under management (AUM) at Prisma. Reddy, Cook, and Rudzik were among a handful of former Prisma owners in line to receive these contingent payments. The former Prisma owners had split $100 million in 2012, another $123 million in 2014, and were working toward the 2017 payout, which was to be the final performance-based contingent payment. At year-end 2015, the contingent 2017 payments were valued at almost $50 million. Each of these men had a very substantial personal stake in the growth of Prisma's asset base. They planned to, and did, use KRS's hedge fund portfolio to increase KKR Prisma's revenue and AUM and thus increase the likelihood of achieving KKR's performance metrics and of receiving their 2017 performance payments.

287. In mid-November 2014, Peden was promoted to CIO of KRS. He was contacted by his old boss and long-time friend and business colleague Cook ("Congratulations Mr. CIO"). The two met at an IHOP on December 3, 2014 to discuss a strategic hedge fund partnership in which KKR Prisma would provide a dedicated portfolio manager to manage and monitor all KRS hedge fund investments — in effect, to do the job that previously had been filled by an internal and non-conflicted KRS staffer (Director of Absolute Return). The partnership they discussed would also entail upsizing KKR Prisma's Daniel Boone Fund by several hundred million dollars, while getting KRS out of the other two Black Box funds of hedge funds. The presentation prepared by Cook mentioned that one material benefit to "partnering with KKR Prisma" would be access to and the support of KKR's global infrastructure. The presentation was

intended to be secret; it was labeled "Confidential and Proprietary" and stated that it was "confidential" and could not be disclosed.

288. This plan was driven in no small part by the desire of Cook, Rudzik, and Reddy to increase their own final KKR earnout payments. Peden was a key and active leader/participant in this scheme. As part of the plan, Peden made it look like he could not find a qualified replacement for Schilling as Director of Absolute Return, creating a rationale for bringing KKR Prisma in to, in effect, fill that role.

289. After more "confidential" (secret) communications among at least Cook, Rudzik, and Peden, and the preparation of another KKR presentation approved by Peden, the KRS I.C. agreed on May 5, 2015 to the KKR Prisma "Strategic Partnership" proposal first proposed by Cook. The full KRS Board subsequently approved this action by the I.C. Reddy and Rudzik made the presentation to the I.C., and Peden "strongly" endorsed the plan and helped push it through the I.C. Neither the Investment Committee nor the Board addressed or waived the various conflicts of interest. The arrangement was subsequently formalized in a non-public (secret) Advisory Services Agreement ("ASA"), which was signed by Peden and Thielen, then the Executive Director of KRS. The ASA itself was not presented to or approved by the either the Board or the Investment Committee. The ASA explicitly approved self-dealing by KKR Prisma, to benefit it and the persons entitled to receive the earnout payments, including among others Cook, Rudzik, and Reddy.

290. The "Strategic Partnership" allowed Rudzik and his team of KKR employees to take up positions inside KRS while still on KKR's payroll, purportedly to assist KRS staff gain "in-house" hedge fund expertise so it could "build out its direct hedge fund portfolio" and thereby reduce the huge fees and low returns the Black Box

fund of hedge funds carried. However, the real intent and effect of this "Strategic Partnership" was to hand control over KRS's entire $1.6 billion portfolio of absolute return investments to KKR/Prisma/Cook/Rudzik/Reddy and then permit them to manipulate that position for their own personal financial benefit and that of KKR and KKR Prisma. Placing Rudzik and his KKR Prisma team in charge of overseeing the absolute return investments, with no supervision with the exception of Peden himself, was not a plan to "help" KRS staff — it was a plan to replace inside, unconflicted staff with very conflicted KKR executives working inside of KRS in violation of KRS conflict of interest policies and Kentucky law. This scheme (including the secret ASA, with its unlawful approval of self-dealing) reflected anything but the sole interest, exclusive benefit fiduciary regime imposed by Kentucky law.

291. Peden falsely told the Investment Committee and the Board that KKR Prisma was willing to perform these "advisory" services for free, because doing so "makes for a stronger relationship with the client [KRS]." But the ASA revealed that the real "consideration" flowing to KKR included a large increase in KRS investment dollars into KKR Prisma's Daniel Boone Fund, and "the opportunity for [KKR Prisma] to expand its industry knowledge and ***develop further business relationships with third parties through the provision of services under this Agreement***," *i.e.*, use KRS's assets to benefit its business. Thus, Peden not only arranged for KKR Prisma to get hundreds of millions more in its Daniel Boone Black Box, but also for KKR/Prisma/Cook/Rudzik to become the gatekeeper (without effective staff oversight) of KRS's entire $800 million direct hedge fund portfolio, and to leverage that gatekeeper position to extract improper self-dealing benefits. That KKR/Prisma could also use the

arrangement to cause KRS to divest funds managed by KKR/Prisma's competitors was an added bonus.

292. With Rudzik and other KKR employees inside KRS and with Peden's influence as CIO, these co-conspirators used their influence to persuade the KRS Trustees to agree to sell off the two better-performing Black Boxes — Blackstone (Henry Clay Fund) and PAAMCO (Newport Colonels Fund) — and to use a large part of the sale proceeds to invest $300 million more in KKR Prisma's Daniel Boone Fund, even though the Daniel Boone Fund was the worst performer of the KRS Black Boxes. The Daniel Boone Fund's since-inception returns trailed the other two Black Boxes by almost 23% when the Investment Committee initially approved the Strategic Partnership with Prisma. And the I.C. made the final decision to invest substantially more in the Daniel Boone Fund at the end of a year in which Daniel Boone lost more than 8% of its value — a one-year loss of more than $40 million. Peden falsely told the I.C. and the Board that KKR Prisma was willing to perform these "advisory" services for free, because doing so "makes for a stronger relationship with the client [KRS]." But the ASA revealed that the real "consideration" flowing to KKR and KKR Prisma included a large increase in KRS investment dollars into KKR Prisma's Daniel Boone Fund, and "the opportunity for [KKR Prisma] to expand its industry knowledge and develop further business relationships with third parties through the provision of services under this Agreement," *i.e.*, use KRS's assets to benefit its business. This concession was worth many millions of dollars to KKR and KKR Prisma in terms of (at least) information, access and deal flow. Thus, Peden not only arranged for KKR Prisma to get hundreds of millions more in its Daniel Boone Black Box, but also for KKR/Prisma/Cook/Rudzik to become the gatekeeper (without effective staff oversight) of KRS's entire $800 million direct hedge

fund portfolio, and to leverage that gatekeeper position to extract improper self-dealing benefits. That KKR/Prisma could also use the arrangement to cause KRS to divest funds managed by KKR/Prisma's competitors was an added bonus. It strains credulity to assume under these circumstances that KKR Prisma was chosen for this role entirely on merit, as it was decidedly not best-in-show. Of the $300 million in fresh cash directed to the Prisma Daniel Boone Fund as a result of the I.C. and Board decisions in May 2016, about half ($150+ million) was directed by KKR Prisma into its own proprietary fund, KKR Apex Tactical Fund, a new fund KKR had just launched. The materially higher fees that flowed to KKR Prisma as a result of directing KRS dollars in its own fund provided additional revenue and AUM to KKR Prisma, thus also benefitting Cook, Rudzik, Reddy, and the others potentially entitled to the contingent KKR earnout payments. In addition, KRS invested $285 million more in other hedge funds recommended by and/or related to KKR Prisma. KKR Prisma thus gained tremendous leverage over the managers of the $285 million of new hedge funds they recommended, as well as over the existing direct hedge fund managers who knew that KKR/Prisma/Rudzik could recommend they be divested at any time.

293. Allowing these KKR executives inside KRS while they remained employed and paid by, and loyal to, KKR was a clear violation of KRS's conflict of interest policy and Kentucky law, even more so since these conflicts were never vetted, no rules were created to avoid or mitigate them, and no information barriers were erected to prevent the conflicted misuse of information. The added power that the secret ASA explicitly created as a means of exploiting these conflicts for the benefit of Rudzik, Cook, Peden and KKR only exacerbated the conflicts.

2016 KKR/PRISMA $300-MILLION SALE
VIOLATED KPL/KRS CONFLICT OF INTEREST PROHIBITIONS
"Free Staff Member" "Partnership" "Extension of Staff" KKR/PRISMA's Rudzik

KENTUCKY RETIREMENT SYSTEMS
CONFLICT OF INTEREST AND CONFIDENTIALITY POLICY

Statement of Conflict of Interest and Confidentiality Policy:
Individuals associated with KRS must not engage in activities that have the potential to become a conflict of interest with their association with KRS …

PROCEDURES REGARDING CONFLICTS OF INTEREST AND CONFIDENTIALITY
Section 1: Application of Policy
(1) **This policy shall apply to all individuals who have a statutory, contractual or working relationship with KRS.**
(2) Individuals affected by this policy shall include, but are not limited to:
a. **Employees of KRS;**
b. KRS Trustees;
c. **Independent contractors of KRS;** and
d. Vendors of KRS.

Section 2: Standards of Conduct Regarding Conflicts of Interest
2. Potential conflicts of interest exist when an individual … **may be directly or indirectly financially impacted,** … by a decision made by KRS in which the individual participates….
5. **Individuals should not conduct business or participate in decisions with a company or agency in which the individual … is employed….**

INDIVIDUALS *ASSOCIATED WITH* KRS PROHIBITED FROM:
- using KRS *confidential information* to further his/employer's economic interests
- participating in decisions involving company employing individual
- having direct/indirect interest in gains/profits of any investments by KRS board

294. At the same time that KKR/Rudzik were moving inside KRS to take control of its hedge fund investment portfolio, the fund of hedge funds industry was "***an industry in crisis***." Fund of hedge fund sellers like KKR Prisma were suffering over $262 billion in outflows/redemptions in less than 12 months, a remarkable loss of 30% of the entire industry's assets under management. The industry was imploding — swamped by an unprecedented tsunami of redemptions — and KKR/Prisma was being badly hurt. By gaining not only an additional $300 million more in assets under management (including $150+ million into its own newly launched fund), but the economic benefits from running the rest of the $1.6 billion portfolio as well, with a free hand to reap profits and benefits for itself, KKR Prisma ***helped itself at the expense of KRS at a time when the hedge fund industry was badly stressed***.

295. While many other public pension funds and other institutional investors were redeeming their hedge fund holdings, and foregoing new hedge fund investments, the tight grip that Peden, Rudzik and KKR Prisma had on KRS's hedge fund portfolio ensured that KRS remained fully invested in hedge funds and in fact adding to its positions.

296. These "investments" were not made "solely'" in the interests of the members and the beneficiaries of KRS, but to benefit KKR Prisma, Peden, Rudzik and Cook. This violated the KRS Conflict of Interest rules, and it also violated the Kentucky Pension Law:

> § 61.650(1)(c) BOARD OF TRUSTEE FUNDS:
>
> A trustee, officer, employee, ***or other fiduciary*** shall discharge duties with respect to the retirement system:
>
> 1. ***Solely in the interests*** of the members and beneficiaries;
>
> 2. For the ***exclusive purpose*** of providing benefits to members and beneficiaries....

297. The additional $300 million Daniel Boone investment — like the original conflicted deal in 2010-11 — was a disaster. As of 9/30/19, Prisma's 3-year return of 3% was materially worse than the 3-year return of more than 4.5% on KRS's fixed income portfolio, and was dwarfed by the 12%+ 3-year return on KRS's U.S. equity portfolio. And KRS was forced to pay more than 2% annually in Management Fees to achieve this 3% growth.

298. Having engineered the plan to embed KKR Prisma inside KRS (in order to expand its influence over KRS's absolute return portfolio earlier in 2015), between December 2015 and January 2016, Cook, Rudzik and Peden began — behind the scenes — to cover their flanks by secretly maneuvering to get Cook appointed to the KRS Board. Peden worked with Rudzik and others with influence to engineer the appointment of Cook (a just-retired KKR Prisma partner with a multi-million dollar stake in KKR and huge performance-based payout) to the KRS board, and David Eager as Vice Chairman of the KRS Board. They succeeded, and Cook was appointed to the KRS Board in early June 2016, literally just days after Peden had used his position and information

advantage to approve motions to (in Peden's words) "clean up the February 2016 and May 2015 Strategic Partnership decisions to make clear that Prisma Daniel Boone [would] be 50% of the Absolute Return portfolio," thereby upsizing Prisma Daniel Boone by $300+ million at Investment Committee and Board meetings that took place on May 5 and May 19, 2016, respectively.

299. Eager was appointed to the KRS Board and joined the Investment Committee in time for its May 5, 2016 meeting, at which Eager made and voted in favor of the motion described in the preceding paragraph. He made and voted in favor of the same motion at the May 19, 2016 Board meeting. In so doing, Eager – who had long been involved in the pension advisory business – either acted without having fully informed himself of the situation as outlined above by Peden (*i.e.*, that the May 2016 motions Eager made were related to and intended to "clean up" the May 2015 and February 2016 Strategic Partnership decisions, implemented through the unlawful Advisory Services Agreements), or with full information about these matters and the attendant conflicts and self-dealing. In either event, Eager knowingly or recklessly violated his own fiduciary duties.

300. However, political change had swept through Kentucky, driven in no small part by the increasingly obvious problems at KRS. This resulted in the appointment of other, new Trustees who were not tied to KKR Prisma, Cook, Peden and/or Rudzik, economically or personally. In short order, these new Trustees would disrupt the ongoing conspiracy.

301. In August 2016, Eager resigned from the Board and became KRS's interim executive director, *i.e.*, CEO of KRS. After that meeting, the new KRS Trustees publicly disclosed the clearly suspicious $300 million KKR/Prisma Daniel Boone hedge fund

purchase to ***loud public outrage***. *See* John Cheves, *Kentucky Pension System Doubling Down on Hedge Fund that Lost Money*, LEXINGTON HERALD LEADER, Aug. 29, 2016, *available at* https://www.kentucky.com/news /politics-government/article98676912.html (last visited Dec. 30, 2020) ("One of the biggest investments held by the $14.9 billion Kentucky Retirement Systems is a hedge fund that's also one of its worst performers — and yet the financially troubled agency is doubling down.").

302. Cook (by this point having been appointed to the KRS Board) and Peden both publicly defended this conflicted investment: Cook said he would "abstain from action related to Prisma because he still has a financial holding in the company," but still publicly defended the new Prisma/Daniel Boone investment in press interviews: "Well, obviously, everyone would like to make more and particularly not lose. But that doesn't necessarily mean it's a bad investment, and it certainly doesn't mean that, looking forward, it's a bad investment … [and] there may be a lot of opportunity"; Peden feigned innocence, saying, "[w]e essentially use [KKR Prisma employees inside KRS] as an extension of our staff, "like having a free staff member" and that ***his long relationship with Prisma and KKR allowed him to use his* "*discretion*" *and* "*made it unnecessary to do a competitive process*."** After Cook was elected to chair the Investment Committee in September 2016, he did nothing to expose or stop the improper and conflicted KKR Prisma presence inside KRS, or disclose or push for termination of the improper ASA and the self-dealing it purported to permit. Nor did Eager (as Executive Director) or Peden (as Chief Investment Officer). All three breached their duties in this and other regards.

303. In October 2016 — literally just weeks after the additional $300+ million had gone into Daniel Boone Fund, and after another $285 million into other hedge funds chosen by Prisma – at special called Investment Committee meeting with the new KRS Chair (Farris) and new Investment Committee Chair (Harris) (both of whom understood hedge funds) in place — the Investment Committee took a fresh look at KRS's hedge fund exposure. The Committee, with Cook recused and forced to abstain due to his obvious conflict of interest, voted unanimously to "exit[] the 10% allocation to absolute return/hedge funds" — or as one journalist put it, to "***end its controversial investments in hedge funds***." Peden was instructed to draw up (with new Trustee Ramsey) a plan to redeem (sell off) all $1.6 billion in hedge funds as quickly as legally possible. (Soon thereafter Peden, who apparently tried to slow the redemption plan, was fired.) Reflecting this new direction by informed, unconflicted Trustees, a presentation at the November 2. 2016 Investment Committee meeting observed that "Hedge Funds as a stand-alone self-diversifying allocation make little sense for KRS [because of] high fees [and] unattractive NET returns." This informed criticism hit the mark. KRS's "investments" in the so-called "absolute return" Black Boxes did not lower risk, reduce illiquidity, or generate sufficient returns to enable KRS to even approach, let alone exceed, the 7.5% rate of return that KRS and its consultant RVK expected from the Absolute Return investments. They *did* however generate excessive fees for the Hedge Fund Sellers, and poor returns and ultimately losses for the KRS Funds, in the end causing substantial damage to KRS.

304. As of 9/30/2019, the "absolute return" investments had in fact returned only 3.49% annually, net of fees, since inception – less than half the expected rate of return. Prisma itself had returned only 3.35% net of fees. As of that date, Prisma's net

returns lagged cash for the most recent one-year period, barely outperformed cash (1.95% vs. 1.34%) over 5 years, and substantially underperformed KRS's fixed income investments over 5 years. These net returns fell far short of expectations.

305. The fees KRS has paid in connection with the Black Boxes — though never publicly quantified or fully disclosed — have been truly astronomical, especially in comparison to these very disappointing net returns. In connection with funds of hedge funds like these, fees are paid at two levels — fees are paid to the fund of funds manager (here, Prisma, PAAMCO, and Blackstone), and fees are also paid to the managers of the individual underlying hedge funds. Moreover, two different kinds of fees are paid at both levels: "Management Fees," representing a percentage of total assets under management paid annually regardless of performance, and "Incentive Fees," representing a percentage of annual profits based on performance. The total fees — Management Fees plus Incentive Fees, at both levels, are the relevant measure — as total fees impact and constitute a drag on net returns. The chart below depicts total fees charged with respect to each of the Black Boxes, according to an internal KRS staff report dated August 15, 2011.

	Total Management Fees	Total Incentive Fees
	off the top	
	% of total assets annually	% of profits annually
Prisma	**2.52**	**24.7**
PAAMCO	**1.95**	**19.7**
BAAM	**2.12**	**29.8**
Average	**2.2**	**24.73**

306. As shown in the chart, ***total Management Fees alone were 2.2% per annum***. With a $1.4 billion initial investment in the Black Boxes, this means that Management Fees alone were almost $31 million in the first year, and they escalated from there based on the size of the Absolute Return portfolio as a whole. ***In other words, from late 2011 through 2016, KRS paid as much as $165 million or more in hedge fund Management Fees***.

307. Incentive Fees were sky high too — KRS was required to pay the hedge funds almost 25% of profits (subject to certain adjustments) — in other words, ***to split profits 3-to-1, on top of the Management Fees***. These Incentive Fees have never been publicly disclosed, but ***a rough estimate is that KRS may have paid as much as another $100 million or more in Incentive Fees to the hedge fund managers, on top of the approximately $165 million in Management Fees***.

308. All told, ***it is likely that KRS paid as much (or more) in total fees as it received in net returns on its hedge fund investments***. These astronomical fees not only represented a drag on annual returns; the compounding effects of year after year of huge, excessive fees has made matters much worse.[25] As one KRS staff memo tartly observed, "it is no surprise that the best performing fund of funds in the Absolute Return portfolio has the lowest fees, and vice versa."

309. These fees have largely been hidden from KRS members and the public. The Court should order the Hedge Fund Sellers to provide a complete accounting of all fees paid — Management Fees and Incentive Fees, both at the fund of funds level, and at

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[25] Over the next 5 years, assuming even a 5.5% rate of expected return, the estimated $265 million paid out in hedge fund fees could have earned $75 million or more had the excessive fees not been taken out of KRS.

the underlying manager level. This information should have been made public years ago. In 2016, Governor Bevin issued an Executive Order requiring KRS to post on its website information reflecting "all … fees and commissions for … each individual manager, including underlying individual managers in fund [of] funds and … shall include any profit sharing, carried interest, or other partnership incentive arrangements or agreements." KRS, under Eager's leadership, has never disclosed these fees. The 2016 Comprehensive Annual Financial Report, for example, stated that Management Fees for the Absolute Return portfolio totaled $9.13 million. In fact, however, Management Fees for fiscal 2016 — including Management Fees paid to the underlying hedge fund managers in the Black Box funds of funds — came to $30 million or more. In other words, the 2016 CAFR understated Management Fees for the Absolute Return portfolio by $20 million or more. Whether the "lay" members of the Board understood that Management Fees had been drastically unstated, Executive Director Eager and Investment Committee Chair Cook — both career professionals with long experience in pension fund investing — surely did, especially since the ink on Executive Order 2016-340, which required reporting of fees charged by underlying managers in funds of funds, was barely dry.

310. Unfortunately, before Farris, Harris, Ramsey and the others intervened to disrupt the ongoing drain, the KKR/Prisma/Cook/Peden/Rudzik plan largely succeeded. Due to the pernicious "lock-up" provisions hedge fund sellers put into their contracts, they get to keep a client's money — and pocket huge fees — for years after they get it, no matter how badly the hedge fund performs. So while Farris and others had stopped the ongoing misconduct, it was too late for KRS. Due to disadvantageous "lock-up" provisions, KKR Prisma, KKR Apex Tactical Fund, and other hedge funds related in

some way to KKR got to keep hundreds of millions of investment dollars for many more months. These May 2016 Cook/Peden/Rudzik-engineered KKR Prisma-conflicted hedge fund investments from KRS helped KKR's hedge fund business through a very rough patch of over $262 billion in hedge fund redemptions, and generated millions in fees and other benefits.

311. The Trustees who voted at Investment Committee and Board meetings to approve the formation of the "Strategic Partnership" with KKR Prisma (May 2015), to approve making the "Strategic Partnership" permanent (February 2016), to approve the $300 million upsize of the Prisma Daniel Boone Fund (May 2016), and/or to approve other actions in connection with the "Strategic partnership" were (i) uninformed as to the material facts (and thus acting in breach of their duties); (ii) uninformed as to the material facts because Peden and/or his co-conspirators misled them; or (iii) knew about the material facts (including inter alia any or all of the conflicts of interest) and voted in disregard of the material facts and in breach of their fiduciary duties.

312. As a key part of the ongoing course of misconduct and conspiracy in late 2015 and early 2016, Peden and Rudzik worked together behind the scenes to engineer the appointment of Cook to the KRS Board. None of Cook, Peden, or Rudzik disclosed their prior wrongdoing as alleged, and in particular failed to disclose the very serious conflict of interest created by the self-dealing provisions of the still-secret ASA — a conflict that continued to benefit Cook after he became a member of the KRS Board. Cook got appointed on June 17th, just days after the May 19, 2016 conflicted investments had been finally approved.

313. Because they are trustees and because they watch over the life savings (Trust Funds) of members and over taxpayer contributions to the Trust Funds in a non-

profit enterprise, where the trust beneficiaries and taxpayers are ***involuntary participants***. Neither the Trustees nor those who worked with them to disadvantage or damage KERS are entitled to shield their actions and/or misconduct by the so-called "Business Judgment Rule" defense applicable to for-profit public corporations where shareholders can sell their shares and walk away if they are dissatisfied with the stewardship.

D. Defendants' False and Misleading Statements and Reassurances — and Obfuscations — to KRS Members

314. As required by the Kentucky Pension Law, every year the trustees published a Comprehensive Annual Report for KRS members, government officials and taxpayers. It is the primary means of communication by the trustees to KRS members and Kentucky taxpayers. It was required to be in "easily understood language" to allow KRS members and beneficiaries, government officials and taxpayers to be informed as to the true financial and actuarial condition of the KRS Funds and the stewardship of the trustees.

315. The police, clerks and social workers, the firefighters, sheriffs and the like, who are members of the KRS Plans are not required to be forensic accountants or actuaries or lawyers with fiduciary and trust expertise. They are not required to be private eyes, searching through 180-page-long, two-pound Annual Reports to ferret out if Trustees, who are supposed to be looking after them, are telling them the truth as the Kentucky Pension Law requires them to do. The Annual Reports published by the trustees during the relevant time period did not give a true, accurate or "fair presentation" of the actual financial and actuarial condition of the KRS Plans in "easily understandable" language. Instead, over the past several years the Defendants have