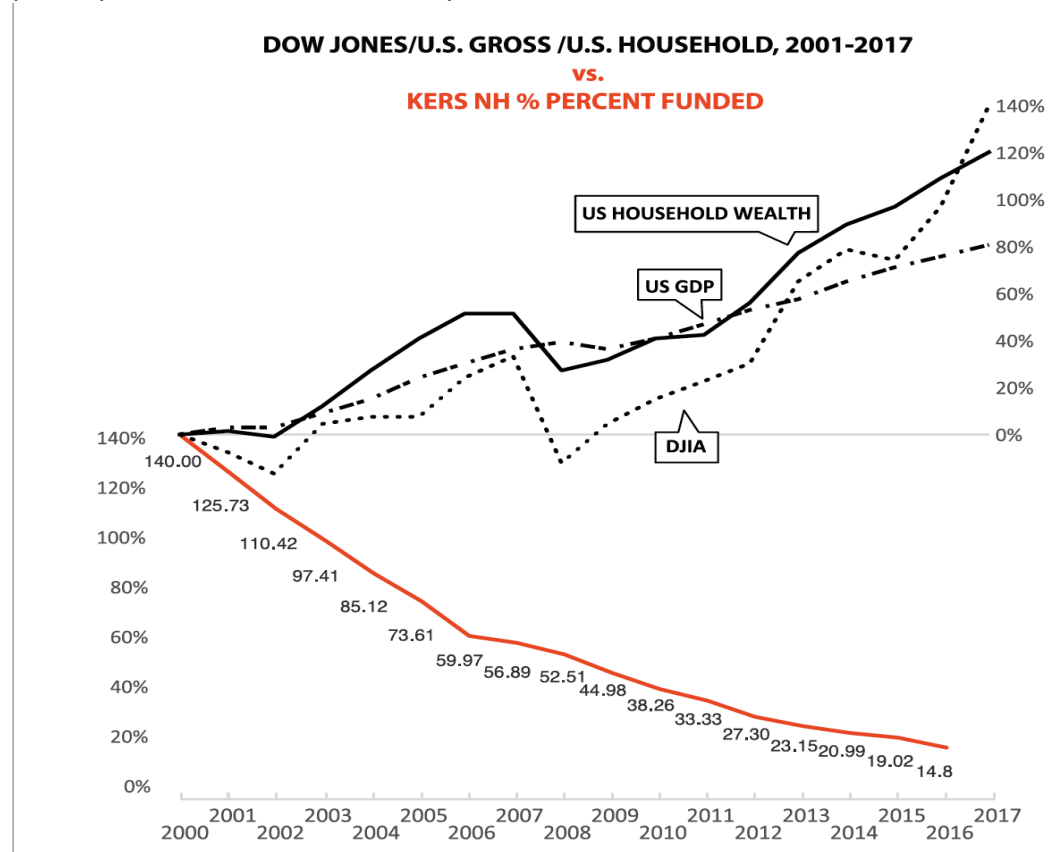


MAYBERRY V. KKR & CO. LP – CASE SUMMARY

Three international hedge fund sellers and their top executives are being called to account for targeting and selling unsuitable “black box” investments to the Kentucky Retirement Systems¹ in a derivative suit filed by current and former public employees, whose retirement funds have been decimated. With the sales of these mysterious, risky, hedge-fund-of-fund vehicles, KKR/PRISMA, BLACKSTONE and PAAMCO² are accused of breaching their fiduciary duties and creating a false sense of security about the true nature of these investments, whose massive fees, lack of transparency, sub-par returns and later large losses helped cripple the KRS funds, significantly contributing to the current underfunding crisis in Kentucky’s pension systems.³ Had the trustees not been sold the black boxes and the funds invested in prudent investments, like simple, no-frills, low-fee index funds, the KRS funds would be vastly better off. Instead, KRS’s largest fund – once overfunded – is now a mere 14% funded,⁴ the worst-performing (most severely underfunded) public pension fund in the country.⁵



¹ The Kentucky Retirement Systems encompasses the following Pension Trust Funds at issue in this case: The Kentucky Employee Retirement System – Non-Hazardous (KERS-NH) and Hazardous (KERS-H), the County Employee Retirement System – Non-Hazardous (CERS-NH) and Hazardous (CERS-H) and the State Police Retirement System (SPRS), the largest of which is the KERS-NH.

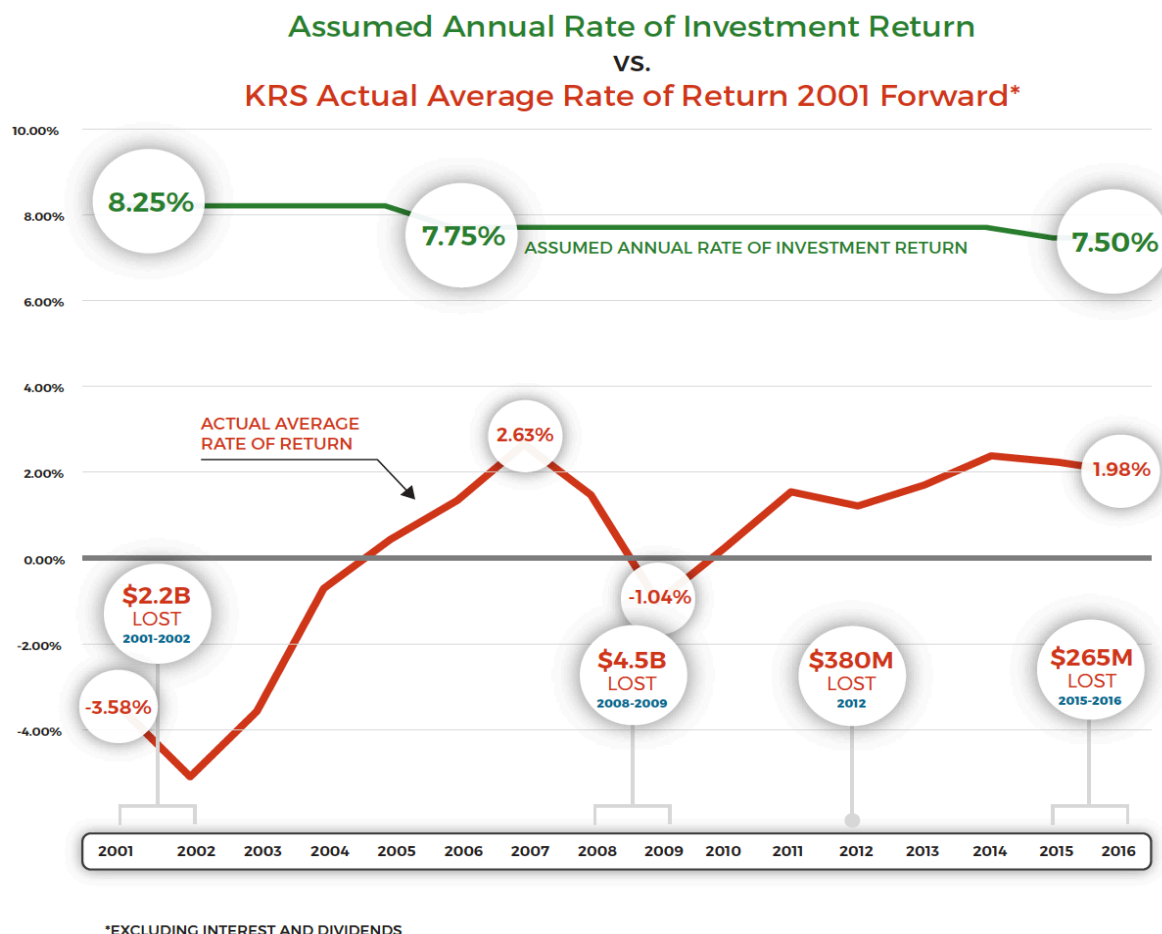
² Hedge fund seller defendants are: KKR & CO., L.P./PRISMA CAPITAL PARTNERS, L.P. (KKR/Prisma); BLACKSTONE GROUP, L.P. (BLACKSTONE); PACIFIC ALTERNATIVE ASSET MANAGEMENT COMPANY, LLC (PAAMCO); KKR Co-Founders/CEOs HENRY KRAVIZ & GEORGE ROBERTS and GIRISH REDDY, Prisma Founder and Co-Chair/CEO of KKR/Prisma/PAAMCO; Blackstone Founder and CEO STEVEN A. SCHWARZMAN and its Vice Chair J. TOMILSON HILL; and JANE BUCHAN, PAAMCO Founder and Co-Chair/CEO of KKR/Prisma/PAAMCO. At the time of the first sale of black box funds of hedge funds to KRS, the sellers were Prisma (prior to its acquisition by KKR), Blackstone and PAAMCO (prior to its acquisition by KKR/Prisma). KKR/Prisma participated in subsequent transactions, including the retention of the Prisma black box fund by KRS, and the sale of \$300M more of its Daniel Boone Fund to KRS in 2015-2016. We use “KKR/Prisma” for simplicity, however only the hedge fund transactions post October-2012 included the KKR principals, Kraviz and Roberts.

³ See *All That Glitters Is Not Gold: Analysis of U.S. Public Pension Investments in Hedge Funds*, Roosevelt Institute 11.06.15 (all of the pension funds included in the analysis (which did not include the KRS funds) “would have performed better having never invested in hedge funds in the first place...”), attached.

⁴ Chart compares market indicators – the Dow Jones Industrial Average, US Gross Domestic Product and US Household Wealth – with the funding status (or percent funded) of KRS’ largest fund, the KERS-NH, from 2000-17.

⁵ <http://wfpl.org/studies-show-kentuckys-state-pensions-worst-in-nation/>

In 2001 KRS was fully funded and had sufficient assets to meet its obligations, but after suffering \$6.7 billion in losses in 2001-02 and 2008-09, KRS found itself in a vise – its liabilities had increased and its assets decreased to the point where even achieving the annual rate of investment return it had been wrongly assuming for years, 7.75% – which it had failed to achieve on an ongoing basis since 2001 – it would still be billions short of the amounts needed to meet its pension promises.⁶



TRUSTEES ARE CAUGHT IN A VISE

An internal 2010 analysis of KRS’s funding status performed by KRS’s investment advisor, defendant R.V. KUHNS, LLC (RVK), revealed the true extent of KRS’s underfunding due to huge investment losses (\$6.7 billion in the 2001-02 and 2008-09 market declines), and the use of outdated, inaccurate and even false actuarial assumptions of annual investment returns (7.75% when the real ongoing averaged returns were never anywhere near these numbers), state hiring (4% employee growth assumption when in fact it was flat or negative), retiree, longevity and inflation rates – all of which placed the trustees in a tightening financial and actuarial vise.

Contrary to their obligations of truthful disclosure in “easily understood” language that Kentucky pension law requires, the trustees, working together with and assisted by defendants RVK, actuarial advisor CAVANAUGH MACDONALD CONSULTING, LLC, and fiduciary counsel & advisor ICE MILLER, LLP, and their top officers, chose to cover up the true extent of the underfunding and

⁶ See above chart, showing cumulative moving average annual rate of investment return from 2001-16, also known as actual average rate of return 2001 forward, **excluding interest and dividends**, as marked; the attached charts in full size include this one, and a corollary chart showing same information including interest and dividends - both well below 7.75%.

take longshot gambles to try to catch up. And defendant Government Finance Officers Association (GFOA), year-after-year, certified that KRS was being truthful and complying with Kentucky law.

BILLION DOLLAR ONE-DAY BLACK BOX PLUNGE

In one fell swoop, these hedge fund sellers convinced the KRS trustees to make the single-largest one-time investment ever – \$1.2 BILLION split among the three of them in three black boxes of other hedge funds. Defendants told the KRS beneficiaries and Kentucky taxpayers these investments were “absolute return” assets, an “absolute return strategy” which would boost returns to help KRS meet or exceed the all-important 7.75% annual rate of investment return, lower the funds’ risk, reduce volatility with “downside protection” and even provide increased, safe diversification. All of which would supposedly help KRS recover from its prior financial losses and improve its financial status. RVK described the trustee’s decision as the “most effective asset allocation strateg[y]” which would “lower risk, control the level of illiquidity in the portfolios and generate a return expected to exceed... 7.75% [because] new allocations to the ... absolute return buckets” would make the portfolio “more diversified than ever.” KRS’ investment advisors, fiduciary advisor and certifiers allowed the trustees to plunge into an over-concentrated hedge fund-of-funds gamble – 10% of the funds’ assets in a single day – into vehicles that had no prior record of investment performance and never provided anywhere near the investment returns needed or downside protection promised and yet consumed hundreds of millions of dollars in fees.

KRS was targeted by KKR/Prisma, Blackstone and PAAMCO for these high-risk, super-expensive, unsuitable “black box” investments, nicknamed Daniel Boone, Colonels, and Henry Clay funds. These were the single-largest investments KRS had ever made, all on a single day in August of 2011. As remarkable as the size of these plunges, was the fact that the trustees took them after having been badly burned in two hedge fund investments shortly before, losing millions when the funds quickly collapsed amidst allegations of impropriety, and later, exposure of “suspicious payments” to “middle-men.” Yet they plunged again – with a 10 times bigger bet.

With assurances to their customers that their exotic products provide positive upside returns along with downside protection and safe diversification, plaintiffs have also sued the hedge funds’ executives – HENRY KRAVIS, GEORGE ROBERTS, GIRISH REDDY, JANE BUCHAN, STEVEN A. SCHWARZMAN and TOMILSON HILL – who are well-known for their hands-on oversight and management of their tightly controlled financial empires. They are named as defendants for either their direct involvement or control of their companies

Prisma was founded by REDDY and ex-Goldman Sachs bankers who agreed “it was time for a fund of funds that could tap into pension funds [because] they knew they wanted hedge fund exposure,” and formed to specialize in selling custom-designed black box hedge funds to public pension funds, like KRS. Defendant DAVID PEDEN, KRS CIO at critical times, came from Prisma. When the Daniel Boone black box began to lose millions in 2015-16, KKR/Prisma got the approval of the KRS trustees to place a KKR/Prisma employee inside KRS in a “partnership” while still on their payroll, in violation of Kentucky pension law. Then, KRS put \$300 million more into KKR/Prisma – the worst-performing hedge fund – while at the same time selling off \$800 million of KRS’s other hedge funds, during the hedge fund industry redemption crisis, caused by customer fury over big fees and poor results.

EXPERT ADVISORS

In addition to RVK, KRS paid CAVANAUGH and ICE MILLER large fees to provide expert advice regarding KRS's investment portfolio, certify its actuarial calculations, and assure the trustees and officers at KRS that they were meeting their fiduciary obligations with regard to the beneficiaries and Kentucky taxpayers under Kentucky pension and trust law. These advisors failed to meet their fiduciary obligations to KRS, allowing the trustees to be sold imprudent, unsuitable, high-risk, high-fee investment vehicles, use false and outmoded actuarial assumptions and issue annual reports filled with false statements and reassurances.

CAVANAUGH certified KRS' actuarial estimates and assumptions, assuring that funding rates established by the KRS trustees were adequate to satisfy the actuarial liabilities as required by Kentucky law, when in fact the assumptions were unrealistic and inaccurate, creating a false sense of security which led to inaccurate and understated funding requests to the Legislature.

As fiduciary counsel, it was ICE MILLER's job to make certain that the trustees and officers at – and those providing expert advice or selling large investments to – KRS were complying with their fiduciary obligations under Kentucky pension and trust law. This included the entire range of the board's conduct as fiduciaries including adequate training, education, oversight, investments, accurate actuarial estimates and assumptions, and purchasing adequate fiduciary liability insurance to protect the KRS beneficiaries and Kentucky taxpayers.

Defendant GFOA "blessed" the actions of all defendants on an annual basis, prominently displayed in the KRS trustees' annual report.

RECOVERY TO BE PROTECTED BY COURT-APPOINTED FIDUCIARY

The plaintiffs – all present and former state and county employees whose retirement benefits are managed by KRS – are suing these entities and individuals derivatively on behalf of KRS and on behalf of the Commonwealth of Kentucky as taxpayers; any funds recovered in the litigation would be deposited into KRS, and not be paid to the plaintiffs directly. The suit is not against KRS or the Commonwealth. The suit is for KRS and Commonwealth taxpayers and any recovery will be for their benefit. Plaintiffs will request it be placed under the supervision of a special fiduciary to be appointed by the court to make sure the net recovery is not wasted or misused as has happened with KRS trust funds and Kentucky tax dollars in the past.

"Despite working in the court system my entire career, I have been oddly reticent to ever pursue litigation personally. However, when I looked into the pension crisis and learned the mistakes that were made in the management of our funds and the failure of the financial professionals to perform basic fiduciary duties on our behalf...could I do nothing? With knowledge and appreciation of the law governing the duties of professionals, how on earth could I stand by?" said plaintiff Brandy O. Brown, a Kentucky District Court Judge. "Since 1993, I have had the privilege to work as an attorney, a prosecutor, and since 2001, as District Judge alongside other state employees: court clerks, police officers, social workers, public defenders, prosecutors, juvenile justice professionals, and a multitude of other state employees across the state. I could never have done *my* job without the dedication and hard work of these people – the heart of our state government, women and men who have served with diligence, loyalty, and commitment to their jobs day-in and day-out – who would have absolutely nothing to rely on without the security of their promised retirement. So no, I simply could not sit idly by."

MONETARY DAMAGES ESTIMATED TO BE IN THE BILLIONS

On behalf of KRS and the Commonwealth, plaintiffs, as members of KRS and as Kentucky taxpayers, are seeking monetary recoveries for increased rescue cost and lost investment opportunities.

Increased Rescue Cost means the increased amounts needed to rescue the funds at present versus what it would have cost if the truth had been told and the true financial condition of KRS disclosed as required by law in 2010, an amount measured in the billions of dollars.

Lost Investment Opportunity is a missed prudent investment alternative. For example, if KRS had invested the \$1.5 billion in a no or low-fee stock index fund, it would have more than doubled. Likewise, if KRS had simply stayed with the existing 2009 asset allocations, the funds would be better off than they are now.

As Berkshire Hathaway CEO Warren Buffett reiterated recently on CNBC's *Squawk Box*, "The S&P 500 'will absolutely kill every one of the fund of funds... Passive investment in aggregate is going to beat active investment because of fees.'"⁷

EXCESSIVE FEES AND LACK OF TRANSPARENCY

Plaintiffs also seek disgorgement of the excessive fees paid to the hedge fund seller defendants for their exotic, unsuitable investments. Hedge fund managers typically justify their fees by claiming to provide outsized returns, such that the higher hedge fund fees pay for themselves. Former KRS trustee Chris Tobe has said that KRS trustees "squandered pensionholders' money by paying high fees for riskier investments with lower returns than unmanaged stock market index funds."⁸ As Buffet noted, "the two-and-twenty fee structure generally adopted by hedge funds (2% management fee plus 20% of profits) means that managers [are] 'showered with compensation' despite, often enough, providing only 'esoteric gibberish' in return."⁹

"These funds can't get them from anywhere besides public pension plans. Corporate plans are too smart to pay these outrageous fees," said Tobe. "The only stupid people are the taxpayers of Kentucky for letting these people get away with this."

Former KRS Executive Director William Thielen admitted he did not know how much money was paid out in fees to the underlying funds – the black box fund of funds – that such information was "proprietary" and had not been revealed to him. Pension funds pay, on average 57 cents of every dollar in net returns from hedge fund investments compared with 5 cents on the dollar in fees for same-sized total fund portfolio.¹⁰

Both KKR and Blackstone have been fined millions for misleading investors by charging hidden, disguised and excessive fees.

"My hope is this case will do several things: one, restore as much as is possible to the funds from the professionals who took commissions and fees in exchange for advising us, yet simply led us to

⁷ <https://www.cnbc.com/2017/10/03/after-winning-bet-against-hedge-funds-warren-buffett-says-hed-wager-again-on-index-funds.html>

⁸ <http://kycir.org/2015/09/15/kentucky-pension-fees-much-higher-than-previously-reported/>; see also *Appropriateness of Risk-Taking by Public Pension Plans*, The Nelson A. Rockefeller Institute of Government, http://www.rockinst.org/pdf/government_finance/2017-02-01-Risk_Taking_Appropriateness.pdf

⁹ *Buffett's Bet with the Hedge Funds: And the Winner Is ...*, <https://www.investopedia.com/articles/investing/030916/buffetts-bet-hedge-funds-year-eight-brka-brkb.asp>

¹⁰ See *All That Glitters Is Not Gold*, attached.

disaster; two, expose what actually got us into this shape so there can be some desperately needed transparency and this situation cannot ever be essentially hidden from the public in the future; and three, institute changes to put into place requirements and monitoring for compliance so that we can be assured the professionals we hire in the future are actually serving our interests,” said Judge Brown. “To me, it really doesn’t seem to be asking for anything less than Kentuckians deserved in the first place!”

OVERSIGHT TO ENSURE RECOVERY HELPS RETIREES

In addition to seeking monetary damages and disgorgement of fees, the suit also seeks appointment of special fiduciary by the court to assure that any recovery is properly utilized to help rehabilitate the pension funds. “I’m not one for litigation, but this suit needed to be brought. Even if we don’t get a dime for the funds to help replenish what was lost – though I certainly hope we will, we might get some reform at the [KRS] board in how our money is managed,” said Plaintiff Jeff Mayberry, a retired Kentucky State Police Captain currently working as a US contractor overseas. “Most of us can’t afford to start over.”

HELP FOR TAXPAYERS LEFT HOLDING THE BAG

In addition to suing derivatively on behalf of KRS, the plaintiffs are also asserting claims on behalf of the Commonwealth as taxpayers, on whom the burden to keep the pension obligations ultimately falls. The more money recovered by the lawsuit the less tax dollars have to be used to bail out the KRS funds. “[S]tate pension plans have invested with hedge funds, and ‘the resulting shortfalls in their assets will for decades have to be made up by local taxpayers.’”¹¹

“It’s not right to take future tax payments to fix this problem,” said Mayberry. “In lieu of or to augment whatever the state may do, hopefully we’ll be able to recover some funds to fill this hole. Because otherwise, either way I’m gonna get to pay for it again. They line us up like it’s a fight between us beneficiaries and taxpayers – but I’ve paid my taxes my whole life, since I was 16.”

“Now I realize there’s an alternative,” said Mayberry. “Nobody said anything about suing those with fiduciary duties overseeing this before now, but if this suit can keep the retirements safe and not reach into the pockets of taxpayers to do it, I’m all for it.”

“And maybe it will encourage a few things to make sure this doesn’t happen again,” he added.

PLAINTIFFS

The plaintiffs are all citizens of and taxpayers in the Commonwealth of Kentucky, and beneficiaries in one or more of the Pension Systems Trust Funds managed by the Kentucky Retirement Systems (KRS): the Kentucky Employee Retirement Systems, hazardous and non-hazardous, the County Employee Retirement System, hazardous and non-hazardous and the State Police Retirement System.

1. **Jeffrey C. Mayberry** was a Kentucky State Police Trooper, Sergeant, Lieutenant and Captain from 1986 to 2011, and is a Member of the State Police Retirement Plan.
2. **Hon. Brandy O. Brown** was a Judicial Clerk, an employee of the Administrative Office of the Courts (1993-1995), and Assistant County Attorney (1995-2001), and is now a

¹¹ <https://www.investopedia.com/articles/investing/030916/buffetts-bet-hedge-funds-year-eight-brka-brkb.asp>

member of the judiciary in the 25th judicial District and a member of the Kentucky Employee Retirement System – Non-Hazardous.

3. **Martha M. Miller** was a Deputy Court Clerk from November 1977 to 2015 and Chief Deputy Court Clerk from 2015 to the present, and is a member of the County Employee Retirement System – Non-Hazardous.
4. **Steve Roberts** was a City of Richmond, Kentucky, EMT/Firefighter from September 1981 until September 2014, and is a member of County Employee Retirement System – Hazardous.
5. **Teresa M. Stewart** is an employee of the Department of Health and Human Services where she is employed as a social worker and has been since 1996. Ms. Stewart is a member of Kentucky Employee Retirement System – Non-Hazardous.
6. **Don D. Coomer** was a Louisville, Kentucky Fire Company Commander from 1971 to 2000 and is a member of the County Employee Retirement System – Hazardous.
7. **Jason Lainhart** worked in the Kentucky Department of Military Affairs (1995-1997), the Louisville, Kentucky Police Department (1997-2016), and the Kentucky National Guard (1992-2010), and is a member of the Kentucky Employee Retirement System – Non-Hazardous and the County Employee Retirement System – Hazardous and Non-Hazardous.
8. **Ben Wyman** was a Law Clerk (1999-2001) and Assistant County Attorney (2001-2016) at the Jefferson County Attorney's Office, and is a member of the County Employee Retirement System – Non-Hazardous.

ADDENDA

HEDGE FUND is an alternative investment using pooled funds that employ numerous different strategies to earn active return, or alpha, for their investors. Hedge funds may be aggressively managed or make use of derivatives and leverage in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). One aspect that has set the hedge fund industry apart is the fact that hedge funds face less regulation than mutual funds and other investment vehicles.¹²

FUND OF FUND is a hedge fund that invests in other hedge funds.

BLACK BOX HEDGE FUNDS are vehicles where the “investor” knows little if anything about the contents of the vehicle or how the money is being “invested.” This secrecy is usually based on a claim by the hedge fund seller/manager that the methods and strategies and fees of the fund are sophisticated, secret and successful. They are proprietary and cannot be disclosed for fear of losing claimed competitive advantages. Refers to the fact that the funds the hedge funds invest in are secret and opaque and the investor does not know what they are investing in or what investment techniques they are employing.

WHAT IS A DERIVATIVE LAWSUIT?

A derivative lawsuit ordinarily occurs in a corporate context, where a shareholder brings an action on behalf of a corporation to redress harm to the corporation. However, because this action would normally be brought by those charged with running the corporation (its officers and directors), a plaintiff must either make a demand upon the officers and directors to take a certain action or plead demand futility, *i.e.*, that no demand has been made because making it would be futile, and therefore the shareholder should be permitted to proceed without going through a futile process. A derivative action serves an important policing function in providing a mechanism of enforcement of fiduciary duties; “[i]f the duties of care and loyalty which directors owe to their

¹² <https://www.investopedia.com/terms/h/hedgefund.asp#ixzz51sjr4gSf>

corporations could be enforced only in suits by the corporation, many wrongs done by directors would never be remedied.”¹³ The ability to enforce fiduciary obligations – and recover damages for failure to meet them – has its roots in trust law and is based upon equitable principles. A derivative action recognizes that persons other than the entity have standing to initiate an action, and provide a mechanism by which those charged with management and control of a venture may be called upon to demonstrate that they are in fact discharging the obligations they have voluntarily undertaken.¹⁴

LAWYERS

Ann Oldfather practices in Louisville, KY (oldfather.com)

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Michelle Ciccarelli Lerach practices in La Jolla, CA (mcllawgroup.com), member, KY Bar

Jon Cuneo practices in Washington, DC (cuneolaw.com)

PENSION CONSULTANT

Pensions Forensics, LLC, owned and operated by **William S. Lerach** (pensionsforensics.com), has been hired by MCL Law Group, APC as a consultant in this litigation.

ATTACHMENTS –

DJIA/GDP/HHW & % UNDERFUNDED KERS-NH FULL SIZE CHART

ASSUMED ANNUAL RATE of INVESTMENT RETURN OF 7.75% V. CUMULATIVE MOVING AVERAGE

ANNUAL RATE of INVESTMENT RETURN (W/O INTERST & DIVIDENDS) FULL SIZE CHART

ASSUMED ANNUAL RATE of INVESTMENT RETURN OF 7.75% V. CUMULATIVE MOVING AVERAGE

ANNUAL RATE of INVESTMENT RETURN (W/ INTERST & DIVIDENDS) FULL SIZE CHART

DRAFT COMPLAINT (EMBARGOED – DO NOT COPY/PASTE – NON-FINAL)

All That Glitters Is Not Gold: Analysis of U.S. Public Pension Investments in Hedge Funds, Roosevelt Institute 11.06.15.

¹³ *Barnett v. S. Conn. Gas Co.*, 374 A.2d 1051, 1055 (Conn. 1977).

¹⁴ Thomas E. Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*.