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Kentucky Court Allows State Pension Plan Bene ciaries to Sue Funds in Which Plan Invested

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On November 30, 2018, a Kentucky County Circuit Court judge denied a motion to dismiss a novel suit filed by eight individual beneficiaries of the Kentucky Employees Retirement System (KRS), which provides pension benefits to retired Kentucky government employees. The plaintiffs purported to bring their suit as a “derivative” action on behalf of KRS and also asserted that they had standing to sue a hedge fund manager and its executives that managed money for KRS by virtue of being Kentucky taxpayers.

The lawsuit grows out of investments made by KRS in hedge funds that the plaintiffs maintain were unsuitable investments (although the performance of the funds met or exceeded the stated target in KRS' investment guidelines). The complaint named not just trustees and officers of KRS as defendants, but private fund managers that had accepted investments from KRS, as well as certain third-party actuarial and investment advisers to KRS and individual executives of these firms. Plaintiffs allege that all the defendants conspired and breached fiduciary duties by covering up shortfalls in KRS’ pension reserves and by having KRS invest in what they characterize as high-risk, high-fee hedge funds. While this is a suit that would likely have been dismissed had it been filed in many other courts (and certainly in federal courts), the Kentucky Circuit Court judge allowed it to proceed.

Most of the defendants filed or joined motions to dismiss which were premised on well-settled federal court decisions (whose standards had just been adopted by the Kentucky Supreme Court in an important decision) requiring that for plaintiffs to have standing to bring suit, plaintiffs (among other requirements) must themselves have suffered a concrete injury affecting them in personal and individual ways.

In rejecting the defendants’ motions to dismiss:

- The Kentucky judge analogized beneficiaries of a state pension plan to shareholders of a private corporation, suggesting that, just as shareholders of private corporations are sometimes permitted to bring derivative suits on behalf of corporations in which they have invested, individual beneficiaries of KRS should be permitted to pursue claims “derivatively” on behalf of KRS. In doing so, the Kentucky judge did not address fundamental differences between a state entity like KRS and a private corporation as well as the fact that the plaintiffs here had not satisfied the demand requirement applicable to derivative actions in the shareholder context (that the plaintiff either have demanded that the corporation’s board file suit or that it show demand would have been futile).
- The Kentucky judge also held that the plaintiffs could satisfy the standing requirement by virtue of being Kentucky taxpayers — a result that is based on a far broader view of taxpayer standing than courts traditionally apply (and potentially inconsistent with the recent Kentucky Supreme Court decision adopting the strict standards used by federal courts to measure whether a plaintiff has the individual concrete injury required for standing).
- The Kentucky judge also held that the complaint contained allegations sufficient to imply a common law fiduciary relationship between the private fund managers and KRS. The judge did not reject the plaintiffs' contention that a fiduciary duty could be deemed to arise during the negotiations to become an investment manager and regardless of provisions in the contracts between the funds and KRS limiting their respective duties.

This case is significant for private fund managers that have accepted or are considering accepting investments from Kentucky plans, as such managers could face liability to Kentucky pension plan beneficiaries on investments made by the plans.

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