

July 14, 2020

Kentucky Supreme Court Dismisses \$50 Billion Derivative Action Against Hedge Fund Managers for Lack of Standing

In a unanimous decision issued on July 9, 2020, the Kentucky Supreme Court dismissed a \$50 billion derivative action brought by eight individual beneficiaries of the Kentucky Retirement System (“KRS”) against three hedge fund managers, as well as certain former and current KRS trustees and officers, actuaries, and advisors, on the ground that the plaintiffs lacked standing to sue under the Kentucky State Constitution because they had not alleged any actual injury. Given the rise in lawsuits being filed by underfunded pension plan beneficiaries, the decision in *Overstreet v. Mayberry*, 2019-SC-000041-TG (Ky. July 9, 2020) (“Slip op.”), which drew heavily from U.S. Supreme Court and other federal precedent, is likely to have substantial impact in other state courts that apply federal constitutional standing principles, or whose state constitutional standing requirements mirror federal requirements.

Background

The action was filed in December 2017 in Franklin County Circuit Court by eight individual defined-benefit plan beneficiaries of KRS who purported to sue derivatively on behalf of KRS, and as taxpayers on behalf of the Commonwealth of Kentucky. Plaintiffs alleged, among other things, that Blackstone Alternative Asset Management Company, L.P. (“BAAM”), Prisma Capital Partners, LP (“Prisma”), and Pacific Alternative Asset Management Company, LLC (“PAAMCO”) had breached fiduciary duties by unlawfully selling KRS custom funds of hedge funds that were purportedly “unsuitably risky” and provided for “exorbitantly high fees” in light of KRS’s deteriorating financial condition.¹ Plaintiffs also alleged that BAAM, Prisma, and PAAMCO conspired with dozens of former and current KRS trustees, officers, and advisors to hide the risky nature of these investments from the public. Notably, plaintiffs asserted these claims even though (i) KRS had pre-approved an allocation of 10 percent of its investment portfolio to absolute-return strategies (such as funds of hedge funds) in 2011; (ii) KRS selected the hedge funds after a careful bidding process during which KRS was advised by outside investment consultants and lawyers; and (iii) the hedge funds generated hundreds of millions of dollars in profits for KRS, net of fees. Moreover, plaintiffs themselves receive a fixed pension benefit payment each month—they did not claim that their vested or expected retirement benefits had been reduced or otherwise been made unavailable to them, and they remained legally and contractually entitled to receive those payments for the rest of their lives. Plaintiffs sought nearly \$50 billion in damages, an amount equivalent to the entire KRS funding deficit accrued over more than two decades.

¹ Paul, Weiss represents the Blackstone entities in this litigation.

In February 2018, multiple defendants, including BAAM, moved to dismiss the complaint on various grounds, including that plaintiffs lacked statutory and taxpayer standing to sue. In November 2018, the trial court denied that motion.

Shortly before the motion to dismiss was denied, however, the Kentucky Supreme Court issued its decision in *Commonwealth Cabinet for Health & Family Services v. Sexton*,² which for the first time incorporated a standing requirement under the State Constitution. Under *Sexton*, a plaintiff suing in Kentucky is required to satisfy the federal test for constitutional standing articulated by the U.S. Supreme Court in *Lujan v. Defenders of Wildlife*.³ Invoking the new *Sexton* standard, BAAM petitioned for and secured from the Kentucky Court of Appeals the exceptional relief of a writ of prohibition ordering that plaintiffs' lawsuit be dismissed on constitutional standing grounds. The case then made its way to the Commonwealth's highest court, together with separate appeals by KRS's trustees and officers on qualified immunity and standing grounds.

The Kentucky Supreme Court

On July 9, 2020, the Kentucky Supreme Court ruled unanimously that plaintiffs did not allege an injury in fact that is concrete or particularized, and therefore lacked constitutional standing to assert their claims on behalf of KRS and the Commonwealth. Accordingly, the Court reversed the trial court's order and remanded with direction to dismiss the complaint.⁴

The Court explained that constitutional standing is defined by three requirements: (1) injury, (2) causation, and (3) redressability.⁵ "To establish the first requirement, 'an injury must be concrete, particularized, and actual or imminent; fairly traceable to the challenged action; and redressable by a favorable ruling.'"⁶ "For an injury to be 'particularized,' it must affect the plaintiff in a personal and individual way."⁷ Citing U.S. Supreme Court precedent, the Kentucky Supreme Court added that "threatened injury must be *certainly impending* to constitute injury in fact" and that "[a]llegations of *possible* future injury' are not sufficient."⁸

Plaintiffs asserted four alternative standing arguments, including that they had standing (1) in their own right to sue on the theory that plan mismanagement had increased the risk of plan default; (2) in a derivative or representational capacity to sue on behalf of KRS; (3) as common-law beneficiaries of a trust; and (4) in

² 566 S.W.3d 185 (Ky. 2018).

³ 504 U.S. 555 (1992).

⁴ Because the Court held that plaintiffs lacked constitutional standing, it did not reach the qualified immunity issue.

⁵ Slip op. at 9-10 (citing *Sexton*, 566 S.W.3d at 196).

⁶ *Id.* at 10 (quoting *Clapper v. Amnesty Int'l USA*, 568 U.S. 398, 409 (2010)).

⁷ *Id.* (quoting *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540, 1548 (2016)).

⁸ *Id.* (quoting *Clapper*, 568 U.S. at 409 (emphases and alteration in original)).

their own right as taxpayers or in a derivative capacity as taxpayers suing on behalf of the Commonwealth. The Kentucky Supreme Court rejected each argument in turn.

No Direct Injury to Plaintiffs

The Kentucky Supreme Court observed that if plaintiffs had not received their vested monthly pension benefits, they would “certainly have the requisite injury in fact to support standing. But plaintiffs at this point *have* received and will continue to receive all their monthly pension benefits.”⁹ Instead, plaintiffs merely alleged that the plan’s underfunding was a result of mismanagement and risky investments, which the Court held was insufficiently concrete and particularized.

That conclusion was consistent with the U.S. Supreme Court’s recent decision in *Thole v. U.S. Bank N.A.*,¹⁰ which addressed the standing of participants in a defined-benefit pension plan governed by the Employee Retirement Income Security Act of 1974, commonly known as ERISA. In *Thole*, the U.S. Supreme Court ruled that such defined-benefit plan participants lack Article III standing to sue the plan’s fiduciaries based on losses to the plan that do not result in individual financial injury. The *Thole* petitioners lacked such an injury because, regardless of the alleged losses to the plan, they remained legally and contractually entitled to receive the same monthly payments in the future.

The Court acknowledged that *Thole* left “unaddressed” whether a plaintiff may assert standing on the basis of an increased-risk-of-harm theory because the plaintiffs in that case had not made that argument before the Court.¹¹ However, even if that theory were available, as the U.S. Supreme Court put it, “a bare allegation of plan underfunding does not itself demonstrate a substantially increased risk that the plan and the employer would both fail.”¹² The Kentucky Supreme Court concluded that “Plaintiffs ha[d] only alleged that the plan mismanagement increases the relative likelihood that the Commonwealth—an entity with taxing authority and the inability to avoid its obligations through bankruptcy—w[ould] eventually have to fund the KRS plan’s actuarial shortfall or pay Plaintiffs their benefits directly.”¹³ The Court then rejected that allegation as “too speculative and hypothetical to confer standing for defined-benefit beneficiaries.”¹⁴

No Derivative or Representational Standing

Plaintiffs alternatively asserted standing in a derivative or representational capacity on behalf of KRS. Relying on *Thole*, the Kentucky Supreme Court held that such an injury is insufficient to confer standing on

⁹ Slip op. at 11 (emphasis in original).

¹⁰ 140 S. Ct. 1615 (2020).

¹¹ Slip op. at 16.

¹² *Id.* at 16-17 (quoting *Thole*, 140 S. Ct. at 1622) (emphasis omitted).

¹³ *Id.* at 18.

¹⁴ *Id.*

the part of the plaintiffs because they lack a continuing financial stake in the litigation. Simply put, “the actual plaintiff named in the lawsuit [must] show his or her own, particularized injury.”¹⁵

No Standing as Trust Beneficiaries

Plaintiffs also asserted common-law trust principles of standing, arguing that a beneficiary of a trust can sue a third party when the trustees cannot or will not do so, to the detriment of the beneficiary’s interest. Relying on *Thole* and federal circuit case law, the Kentucky Supreme Court rejected this argument because participants in a defined-benefit plan possess no equitable or property interest in the plan’s assets and thus possess no concrete stake in the action.¹⁶

No Taxpayer Standing

Finally, plaintiffs asserted that they possessed standing as taxpayers to sue in their own right or, perhaps, derivatively on behalf of the Commonwealth. The Kentucky Supreme Court recognized that it has “never allowed a [taxpayer] suit like this” to proceed and held that the allegations here, where plaintiffs seek damages from private third parties and KRS officials in their individual capacities for tort damages allegedly sustained by all Kentucky taxpayers, were readily distinguishable from typical taxpayer suits lodged against government bodies or their agents to challenge the propriety of a tax or expenditure of public funds.¹⁷

Critical Takeaways

The impact of the *Mayberry* holding likely will extend well beyond Kentucky’s borders. At the time the complaint was filed, Kentucky had the most underfunded pension system in the country.¹⁸ Several other States currently have depleted pension systems (*i.e.*, Colorado, Connecticut, Hawaii, Illinois, New Jersey, Pennsylvania, Rhode Island, South Carolina, among others).¹⁹ By drawing on U.S. Supreme Court and other federal decisions from the ERISA context to reject plaintiffs’ standing theories, the Kentucky Supreme Court offered a widely applicable decision roadmap for other states faced with similar “derivative” suits brought on behalf of defined-benefit plans. The decision is most likely to have an impact on states that already have imported federal rules of standing into their state law, including Hawaii, Illinois, Pennsylvania, Rhode Island, and South Carolina.²⁰

¹⁵ Slip op. at 25.

¹⁶ Slip op. at 28.

¹⁷ Slip op. at 31-33.

¹⁸ Janelle Cammenga, *How Well-Funded Are Pension Plans in Your State?*, Tax Foundation (Apr. 15, 2020), <https://taxfoundation.org/state-public-pension-plan-funding-coronavirus/>.

¹⁹ Pew Charitable Trs., *Public Sector Retirement Systems: 2018 State Aggregate Information* (June 2020), <https://www.pewtrusts.org/-/media/assets/2020/06/statepensionfundingap2018.pdf>.

²⁰ Wyatt Sassman, *A Survey of Constitutional Standing in State Courts*, 8 Ky. J. Equine, Agric., & Nat. Resources L. 349, 353 n.17 (2016).

While the Kentucky Supreme Court's decision should discourage would-be plaintiff-beneficiaries from asserting claims in which they have no direct stake, it remains to be seen whether pension plan fiduciaries will step in to directly assert those claims. Unlike individual beneficiaries of defined-benefit state pension plans who lack standing to assert claims on behalf of their plans, boards of fiduciaries that administer those plans bringing such claims would be politically accountable for their decision-making, not to mention risk fewer future investment options if investment advisors become concerned that underfunded plans present significant litigation risk. Even apart from the procedural rulings of the case, other courts outside Kentucky may be equally motivated to prevent individual actors to second-guess the investment decisions of state pension boards that are ultimately accountable to the public by democratic means.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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