FILED
AUG 2 6 2014
FRANKLIN CIRCUIT COURT
SALLY JUMP, CLERK

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION II
CIVIL ACTION NO. 14-CI-1080

JOSEPH N. POPE, JR., DEPUTY REHABILITATOR OF KENTUCKY SCHOOL BOARDS INSURANCE TRUST WORKERS' COMPENSATION SELF INSURANCE FUND AND DEPUTY REHABILITATOR OF KENTUCKY SCHOOL BOARDS INSURANCE TRUST PROPERTY AND LIABILITY SELF INSURANCE FUND

PLAINTIFF

V.

COMPLAINT

KENTUCKY LEAGUE OF CITIES, INC.

SERVE: R. TEMPLE JUETT
100 EAST VINE STREET
SUITE 800
LEXINGTON, KY 40507

KENTUCKY LEAGUE OF CITIES INSURANCE SERVICES ASSOCIATION

SERVE: R. TEMPLE JUETT
100 EAST VINE STREET
SUITE 800
LEXINGTON, KY 40507

KENTUCKY SCHOOL BOARDS ASSOCIATION

DEFENDANTS

SERVE: MICHAEL ALLEN ARMSTRONG
260 DEMOCRAT DR.
FRANKFORT, KY 40601

BOARD OF TRUSTEES OF THE KENTUCKY SCHOOL BOARDS INSURANCE TRUST

SERVE: DURWARD NARRAMORE
CHAIRPERSON
P.O. BOX 495
JENKINS, KY 41537

*** *** ***

Joseph N. Pope, Jr., Deputy Rehabilitator of Kentucky School Boards Insurance Trust Workers' Compensation Self Insurance Fund and Deputy Rehabilitator of Kentucky School Boards Insurance Trust Property and Liability Self Insurance Fund, by counsel, for his Complaint against Defendants Kentucky League of Cities ("KLC"), Kentucky League of Cities Insurance Services Association ("KLCIS"), Kentucky School Boards Association ("KSBA"), and the Board of Trustees of the Kentucky School Boards Insurance Trust ("KSBIT Board of Trustees"), states as follows:

I. JURISDICTION AND VENUE

1. This Court has jurisdiction over this matter because the amount in controversy exceeds the minimum threshold for the jurisdiction to be invoked, because Defendants were at all times engaged in business in the Commonwealth of Kentucky, because the claims set forth herein arise out of Defendants' tortious conduct within the Commonwealth, and because Plaintiff brings this action pursuant to authority granted him under KRS Chapter 304, Subtitle 33.

2. This Court has exclusive jurisdiction over this matter pursuant to KRS 304.33-030(13) and KRS 304.33-040(3); because this matter is related to the delinquency proceedings of Kentucky School Board Insurance Trust Workers' Compensation Self Insurance Fund and Kentucky School Board Insurance Trust Property and Liability Self Insurance Fund; and, because the damages sought in this action are assets of the rehabilitation estate.

3. Venue of this action is properly in the Franklin Circuit Court pursuant to KRS Chapter 304, Subtitle 33.

II. PARTIES

4. Pursuant to KRS 304.33-160, Plaintiff is the duly appointed Deputy Rehabilitator of Kentucky School Board Insurance Trust Workers' Compensation Self Insurance Fund, and the duly appointed Deputy Rehabilitator of Kentucky School Board Insurance Trust Property and Liability Self Insurance Fund. Plaintiff has all the powers and responsibilities granted to the Rehabilitator, including the power to take action as he deems necessary or appropriate to reform and revitalize the insurer. Plaintiff may pursue all legal remedies on behalf of Kentucky School Board Insurance Trust Workers' Compensation Self Insurance Fund and Kentucky School Board Insurance Trust Property and Liability Self Insurance Fund where tortious conduct or breach of any contractual or fiduciary obligation detrimental to the Funds by any officer, manager, agent, employee, or other person has been discovered.

5. Kentucky School Boards Insurance Trust ("KSBIT") was created under an Agreement and Declaration of Trust dated July 7, 1978 between KSBA and certain named trustees therein to provide certain insurance coverage through non-profit self-insurance funds authorized under Kentucky law.

6. There are three separate self-insurance funds within KSBIT, the Workers' Compensation Fund, the Property and Liability Fund, and the Unemployment Fund. Both the Workers' Compensation Fund and the Property and Liability Fund have been placed into rehabilitation pursuant to KRS Chapter 304, Subtitle 33. The Workers' Compensation Fund and the Property and Liability Fund are collectively referred to herein as the "KSBIT Funds."

7. Pursuant to KRS Chapter 304, Subtitle 33, Plaintiff has the authority to bring civil actions on behalf of the KSBIT Funds against "any officer, manager, agent, employee, or other person" whom the rehabilitator has reason to believe engaged in "tortious conduct or breach of any contractual or fiduciary obligation detrimental to [KSBIT]."

8. KSBA is a non-profit Kentucky corporation with its principal office in Frankfort, Kentucky.

9. KLC is a non-profit Kentucky corporation with its principal office in Lexington, Kentucky.

10. KLCIS is an unincorporated association created in 1987 by Interlocal Cooperation Agreement pursuant to KRS 65.210, *et. seq*. for the purpose of providing and administering self-insurance funds for KLC's members. KLCIS's principal office is in Lexington, Kentucky. Upon information and belief, KLCIS is an affiliated organization of KLC.

11. Pursuant to KRS 304.48-140 and 304.50-085, self-insurance groups shall be operated and governed by a board of trustees. The KSBIT Board of Trustees was responsible for, among other things, administering the operations of the KSBIT Funds, safeguarding the assets of the KSBIT Funds, and providing day-to-day management of the KSBIT Funds.

12. The KSBIT Board of Trustees is an entity that can sue and be sued.

III. BACKGROUND

13. The KSBIT Funds' membership includes Kentucky school districts who are members of KSBA, non-profit institutions of higher education, and other tax supported agencies of Kentucky who, between January 1, 1979 and June 30, 2013, participated in the KSBIT Funds.

14. The KSBIT Funds operated for several years in deficit positions.

15. Because the KSBIT Funds' failed to meet the statutory surplus standard for a number of years, the Kentucky Department of Insurance's requirement for certain corrective action was renewed each year.

16. On December 8, 2009, KSBIT, KLCIS and KLC entered into a Master Agreement which, in part, obligated the parties to execute certain Surplus Notes, provided for an

Administration Agreement authorizing KLC and KLCIS to administer the KSBIT Funds, and obligated KSBIT to amend its Declaration of Trust and bylaws.

17. The required amendments to KSBIT's Declaration of Trust and bylaws, in part, increased the number of KSBIT's Board of Trustees to nineteen (19) and entitled KLC to appoint nine (9) of KSBIT's Board of Trustees during the term of the Administration Agreement. The amendments further required that during the term of the Administration Agreement all formal written recommendations made by KLC, acting in its capacity as Administrator for KSBIT, and submitted to the Trustees at a qualified meeting would be deemed accepted by the KSBIT Board of Trustees unless at least ten (10) Trustees, five (5) of whom must be KLC Trustees, voted against the recommendation.

18. KLC thus took control of the KSBIT Board of Trustees on December 8, 2009, by virtue of the Amendment to KSBIT's Declaration of Trust requiring a majority vote to oppose recommendations by KLC.

19. KSBIT, KLC and KLCIS executed the Administration Agreement contemplated in the Master Agreement on December 8, 2009.

20. The Administration Agreement became effective on January 1, 2010, at which point KLC and KLCIS took over administration of KSBIT.

21. The Administration Agreement resulted in the transfer of responsibility for claims handling and loss control administration to KLC and KLCIS.

22. As Administrator, KLC and KLCIS agreed to carry out the policies established by the KSBIT Board of Trustees and provide day-to-day management of the business and affairs of KSBIT in exchange for administrative costs and a percentage of annual gross premiums billed for the liability, property, and workers' compensation lines of coverage.

23. During this same time period, and at all times relevant, KLC and KLCIS provided its own membership insurance coverage through the KLC Workers' Compensation Trust, the KLC Unemployment Compensation Reimbursement Trust, and other affiliated entities.

24. KLC derived a substantial amount of its revenue from the administrative fees and commissions paid by the insurance and financial programs administered by KLC and its affiliated entities.

25. For example, for fiscal year 2008, 87% of KLC revenue came from the administrative fees and commissions paid by the insurance and financial programs administered by KLC and its affiliated entities.

26. On January 6, 2010, KSBIT and KLCIS executed certain Surplus Notes, pursuant to which KLCIS transferred $5,500,000 to the KSBIT Workers' Compensation Fund and $2,500,000 to the KSBIT Property and Liability Fund.

27. Pursuant to the express terms of the Surplus Notes, the Notes were "payable solely out of the surplus of [KSBIT] in excess of $2,000,000." Pursuant to the express terms of the Surplus Notes, this restriction applied to both payments of principal and interest on the Notes, neither of which were to be paid unless a "minimum surplus" existed.

28. Neither KSBIT Fund ever maintained any surplus while being administered by KLC and KLCIS.

29. Despite the lack of surplus, the KSBIT Board of Trustees, KLC, and KLCIS approved and made substantial interest payments to KLC and KLCIS under the Surplus Notes. These interest payments total $1,192,877.

30. KLC, KLCIS, and KSBA considered the $8,000,000 transfer to the KSBIT Funds an "infusion" of cash to the KSBIT Funds.

31. Upon information and belief, and according to newspaper reports in 2009 following KLC and KLCIS's execution of the Surplus Notes, Bill Scott, KSBA's then executive director, said the transaction "eliminates [KSBIT's] deficit and leaves a modest surplus in both of those pools." Scott further said that "public school districts owe a great debt of gratitude to the League of Cities [KLC]." Scott further said this gratitude "will require the school districts to support the pool, going forward." Cheryl Truman and Linda B. Blackford, *KLC to Run Insurance for Schools*, Lexington Herald-Leader (Dec. 9, 2009), http:www.kentucky.com/2009/12/09/1051747/klc-to-run-insurance-for-schools.html.

32. However, in a February 7, 2013 letter to Terry Holliday, Commissioner of Education for the Commonwealth of Kentucky, Scott said the Surplus Notes "did not eliminate the deficit; rather [they] addressed the matter from a regulatory perspective."

33. Upon information and belief, neither Scott nor KSBA ever explained this "regulatory perspective" to KSBIT's members or prospective members.

34. To the contrary, KSBA solicited school districts and KSBIT members to continue supporting the KSBIT Funds following KLC and KLCIS's assumption of control over the KSBIT Funds, misleading KSBIT's members about the true nature of the Funds' financial deficits.

35. On November 5, 2013, KLC submitted an "Assessment Plan and Dissolution Plan for the Worker's Compensation Fund" ("KLC's Assessment Plan") to the Department of Insurance.

36. KLC's Assessment Plan called the transfers evidenced by the Surplus Notes a "cash infusion."

37. KLC's Assessment Plan goes on to state that "from a regulatory perspective, the deficit in the WC Fund was addressed as a result of [the Surplus Notes]. However, the deficit was not actually eliminated since the loan from KLCIS is a liability of the WC Fund and will have to be repaid as part of settling the obligations of the WC Fund in its dissolution." KLC and KLCIS' position is the same with regard to the funds transferred to the Property and Liability Fund.

38. From an accounting perspective, from the time of the transfer to September 2013, the Surplus Notes were not listed or treated as a liability of KSBIT or the KSBIT Funds.

39. The monies transferred pursuant to the Surplus Notes were at all times prior to September 2013 listed or treated as equity of KSBIT and the KSBIT Funds.

40. Doug Goforth, KLC's Chief Insurance Officer, testified in a February 4, 2014 deposition that the Surplus Notes were always a liability of the KSBIT Funds, regardless of how they were treated from an accounting perspective.

41. Goforth and others at KLC signed off on quarterly statements and other filings that did not identify the Surplus Notes as liabilities of the KSBIT Funds.

42. Goforth, during the February 4, 2014 deposition, was asked the following question: "Do I understand you to be saying that the accounting treatment [for the Surplus Notes] was different than reality." Goforth answered that question, "Yes."

43. Therefore, according to Goforth and KLC, KSBIT's members could not know the true financial condition of the KSBIT Funds from examining the KSBIT Funds' financial statements as prepared by KLC and KLCIS.

44. To the contrary, and for example, audited financial statements for the KSBIT Workers' Compensation Fund, for the year ending June 30, 2010, explain that "KLCIS agreed to

purchase from the Trust two surplus notes … for the purpose of reducing the existing deficit." (Emphasis added.) Accordingly, the Surplus Notes were considered "cash flow" in those audited financial statements and not listed, treated, or identified in any way as a liability (or even a potential liability) of the KSBIT Workers' Compensation Fund.

45. Despite the clear language of the Surplus Notes, despite the accounting treatment of the Surplus Notes, and despite the representations made to KSBIT members about the Surplus Notes, KLC, KLCIS, and KSBA now maintain that KSBIT and KSBIT's members, many of whom are school districts with extraordinarily tight budgets, were at all times liable for repayment of the Surplus Notes.

46. On November 5, 2013, KLC, KLCIS, and the KSBIT Board of Trustees (identified as KSBIT), knowing that Rehabilitation proceedings in Franklin Circuit Court were imminent, filed a Complaint in the Franklin Circuit Court seeking an order from the Court that the Department of Insurance must assess KSBIT members to repay KLC and KLCIS the funds transferred pursuant to the Surplus Notes.

47. KLC, KLCIS, and the KSBIT Board of Trustees, all represented by the same counsel, filed the Complaint also on behalf of "KSBIT," naming "KSBIT" as a plaintiff to the action.

48. In other words, KLC, KLCIS, and the KSBIT Board of Trustees, all of whom owed certain duties of care and loyalty to KSBIT's members, sought (and still seek) to increase the amount of KSBIT members' assessments to pay KLC and KLCIS, again despite the clear language of the Surplus Notes, despite the accounting treatment of the Surplus Notes, and despite the representations made by KLC, KLCIS, and KSBA to KSBIT members about the Surplus Notes.

49. KLC and KLCIS's duty was to remedy the deficit and to protect the school districts and members of the KSBIT Funds.

50. Remedying the deficits from "a regulatory perspective" did nothing to protect the school districts and members of the KSBIT Funds.

51. To the contrary, the financial condition of the KSBIT Funds significantly worsened under KLC and KLCIS mismanagement.

IV. FINANCIAL CONDITION OF THE KSBIT FUNDS

52. Based on the years for which financial records are readily available, the Workers' Compensation Fund sustained operating losses during all years, from 1990 through 2013, except 1995, 2004, 2005, and 2006.

53. Those sustained losses eroded the Workers' Compensation Fund's surplus, resulting in a deficit such that the Workers' Compensation Fund has insufficient assets to discharge its legal liabilities and other obligations and maintain required statutory reserves.

54. Because of the nature of workers' compensation claims, the Workers' Compensation Fund could be exposed to liability for members' claims for the next 30 years or more.

55. The total deficit in the Workers' Compensation Fund for the year ending June 30, 2009, the year before KLC and KLCIS began administering the Fund, according to audited financial statements, was $4,480,728.

56. The total deficit in the Workers' Compensation Fund based on the most recent audited financial statements exceeds $37 million, before any adjustments and discounts on reserves.

57. Based on the years for which financial records are readily available, the KSBIT Property and Liability Fund sustained operating losses during all years, from 1995 through 2013, except 1999 and 2007.

58. Those sustained losses eroded the Property and Liability Fund's surplus, resulting in a deficit such that the Property and Liability Fund has insufficient assets to discharge its legal liabilities and other obligations and maintain required statutory reserves.

59. Liability claims against educational institutions can have a long tail because claims involving minors can be filed many years after the occurrence when the minor reaches the age of maturity.

60. The total deficit in the Property and Liability Fund for the year ending June 30, 2009, the year before KLC and KLCIS began administering the Fund, according to audited financial statements, was $933,066. For the year ending June 30, 2008, the Property and Liability Fund, according to audited financial statements, maintained a small surplus.

61. The total deficit in the Property and Liability Fund based on the most recent audited financials exceeds $8 million, before any adjustments and discounts on reserves.

62. The KSBIT Funds' deficits only worsened in the ensuing years under KLC and KLCIS management.

63. KSBIT ceased writing coverage for the KSBIT Funds on June 30, 2013.

64. The KSBIT Workers' Compensation Fund was placed into rehabilitation by the Franklin Circuit Court by order entered November 15, 2013.

65. The KSBIT Property and Liability Fund was placed into rehabilitation by the Franklin Circuit Court by order entered November 15, 2013.

66. The KSBIT Funds, as a result of Defendants' negligence, mismanagement, and breaches of duties, were in such condition that the further transaction of business would have been hazardous, financially or otherwise, to KSBIT's members, dependent injured workers, and the public, generally.

67. KSBIT members, most of whom are school districts and non-profit institutions of higher education, have been assessed over $45 million to cover the KSBIT Funds' deficits.

V. CAUSES OF ACTION

COUNT I – NEGLIGENCE AND NEGLIGENCE PER SE OF KSBIT BOARD OF TRUSTEES

68. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

69. The KSBIT Board of Trustees had common law and statutory duties to govern and oversee the administration of KSBIT.

70. Pursuant to KRS 304.48-140, a self-insurance group's board of trustees shall, among other things, administer the operations of the liability self-insurance group to ensure the funding of all liabilities; safeguard the assets of the group; and, maintain responsibility for all moneys collected or disbursed from the group.

71. Pursuant to KRS 304.50-085, a self-insurance group's board of trustees shall, among other things, administer the operations of the workers' compensation self-insured group to ensure that there is adequate funding to pay compensation required by KRS Chapter 342, that all claims are paid promptly and processed to conclusion, and that all necessary precautions are taken to safeguard the assets of the group; maintain responsibility for all moneys collected or disbursed from the group; provide day-to-day management of the self-insured group; develop rates and collect premium and assessments; and, invest the self-insured group's funds.

72. The KSBIT Funds and the Funds' members are within the class of persons for whose benefit the above-stated statutes were drafted.

73. The KSBIT Board of Trustees was negligent in their management and oversight of the KSBIT Funds.

74. As a result of the KSBIT Board of Trustees' negligence, the KSBIT Funds and KSBIT Funds' members have been damaged in an amount to be proven at trial.

75. The harm sustained by the KSBIT Funds and their members is the type of harm that the above-referenced statutes were designed to prevent.

COUNT II – BREACH OF FIDUCIARY DUTY OF DILIGENCE AND DUE CARE AGAINST THE KSBIT BOARD OF TRUSTEES

76. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

77. The KSBIT Board of Trustees owed to the KSBIT Funds and their members a fiduciary duty to operate the Funds for the ultimate benefit of KSBIT members to accomplish the following: (a) to establish premiums at a sufficient level to ensure the solvency of KSBIT and the KSBIT Funds; (b) to provide financial statements to its regulators and to KSBIT group members that were not materially misleading; (c) to procure and maintain adequate reinsurance coverage to protect group members from liability for the significant assessments that the group members now face; and, (d) to establish and maintain adequate reserves for the payment of claims.

78. The KSBIT Board of Trustees failed to establish premiums at a sufficient level to ensure the solvency of KSBIT and the KSBIT Funds, and failed to establish and maintain adequate reserves for the payment of claims.

79. The KSBIT Board of Trustees failed to exercise reasonably diligence, due care, and skill in managing KSBIT's business and failed to act in good faith.

80. As a direct and proximate result of those failures by the KSBIT Board of Trustees, and as a direct and proximate result of the KSBIT Board of Trustees' breach of their fiduciary obligations, the KSBIT Funds and the Funds' members have been damaged in an amount to be proven at trial.

COUNT III – BREACH OF FIDUCIARY DUTY OF LOYALTY AGAINST KSBIT BOARD OF TRUSTEES

81. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

82. The KSBIT Board of Trustees had an obligation to govern and oversee the administration of KSBIT and the KSBIT Funds.

83. The KSBIT Board of Trustees had a duty to act in good faith, to act in compliance with the law and the governing documents, and to deal fairly with the KSBIT Funds and the Funds' members.

84. The KSBIT Board of Trustees owed a duty of loyalty to the KSBIT Funds and the Funds members, which was breached.

85. The KSBIT Board of Trustees engaged in self-dealing and used its position to benefit itself at the expense of the KSBIT Funds and the Funds' members.

86. The KSBIT Board of Trustees failed to manage the affairs of the KSBIT Funds in the best interests of KSBIT and KSBIT's members.

87. The KSBIT Board of Trustees failed to act in good faith.

88. The KSBIT Board of Trustees' filing of the Declaratory Judgment Action, in conjunction with KLC and KLCIS, against the Department of Insurance, was an express action directly contrary to the interests of the KSBIT Funds and KSBIT's members.

89. As a direct and proximate result of the KSBIT Board of Trustees' breach of their fiduciary obligations, the KSBIT Funds and the Funds' members have been damaged in an amount to be proven at trial.

COUNT IV – NEGLIGENCE OF KLC

90. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

91. KLC owed a duty to KSBIT and to KSBIT's members to administer the business affairs of KSBIT.

92. KLC breached its duty to KSBIT, the KSBIT Funds, and KSBIT's members.

93. As a result of the KLC's negligence, the members of KSBIT and the KSBIT Funds have been damaged in an amount to be proven at trial.

COUNT V - BREACH OF FIDUCIARY DUTY OF DILIGENCE AND DUE CARE AGAINST KLC

94. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

95. KLC owed to KSBIT and its members a fiduciary duty to operate the KSBIT Funds for the ultimate benefit of KSBIT members to accomplish the following: (a) to establish premiums at a sufficient level to ensure the solvency of KSBIT and the KSBIT Funds; (b) to provide financial statements to its regulators and to KSBIT group members that were not materially misleading; (c) to procure and maintain adequate reinsurance coverage to protect group members from liability for the significant assessments that the group members now face; and, (d) to establish and maintain adequate reserves for the payment of claims.

96. KLC failed to establish premiums at a sufficient level to ensure the solvency of KSBIT and the KSBIT Funds, and failed to establish and maintain adequate reserves for the payment of claims.

97. KLC failed to exercise reasonable diligence, due care, and skill in managing KSBIT's business and failed to act in good faith.

98. As a direct and proximate result of those failures by KLC, and as a direct and proximate result of KLC'S breach of its fiduciary obligations, the KSBIT Funds and the Funds' members have been damaged in an amount to be proven at trial.

COUNT VI – BREACH OF FIDUCIARY DUTY OF LOYALTY AGAINST KLC

99. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

100. KLC had an obligation to govern and oversee the administration of KSBIT.

101. KLC had a duty to act in good faith, to act in compliance with the law and the governing documents, and to deal fairly with KSBIT and its members.

102. KLC owed a duty of loyalty to KSBIT and its members, which was breached.

103. KLC engaged in self-dealing and used its position to benefit itself at the expense of KSBIT, the KSBIT Funds, and KSBIT's members.

104. KLC failed to manage the affairs of the KSBIT Funds in the best interests of KSBIT and KSBIT's members.

105. KLC failed to act in good faith.

106. KLC's filing of the Declaratory Judgment Action, in conjunction with KLCIS and the KSBIT Board of Trustees, against the Department of Insurance, was an express action directly contrary to the interests of the KSBIT Funds and KSBIT's members.

107. As a direct and proximate result of the KLC's breach of its fiduciary obligations, the KSBIT Funds and KSBIT's members have been damaged in an amount to be proven at trial.

COUNT VII – NEGLIGENCE OF KLCIS

108. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

109. KLCIS owed a duty to KSBIT and to KSBIT's members to administer the business affairs of KSBIT.

110. KLCIS breached its duty to KSBIT and KSBIT's members.

111. As a result of the KLCIS's negligence, the members of KSBIT and the KSBIT Funds have been damaged in an amount to be proven at trial.

COUNT VIII - BREACH OF FIDUCIARY DUTY OF DILIGENCE AND DUE CARE AGAINST KLCIS

112. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

113. KLCIS owed to KSBIT and its members a fiduciary duty to operate the KSBIT Funds for the ultimate benefit of KSBIT members to accomplish the following: (a) to establish premiums at a sufficient level to ensure the solvency of the KSBIT Funds; (b) to provide financial statements to its regulators and to KSBIT group members that were not materially misleading; (c) to procure and maintain adequate reinsurance coverage to protect group members from liability for the significant assessments that the group members now face; and, (d) to establish and maintain adequate reserves for the payment of claims.

114. KLCIS failed to establish premiums at a sufficient level to ensure the solvency of the KSBIT Funds, and failed to establish and maintain adequate reserves for the payment of claims.

115. KLCIS failed to exercise reasonable diligence, due care, and skill in managing KSBIT's business and failed to act in good faith.

116. As a direct and proximate result of those failures by KLCIS, and as a direct and proximate result of KLCIS's breach of its fiduciary obligations, the KSBIT Funds and the Funds' members have been damaged in an amount to be proven at trial.

COUNT IX – BREACH OF FIDUCIARY DUTY OF LOYALTY AGAINST KLCIS

117. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

118. KLCIS had an obligation to govern and oversee the administration of KSBIT.

119. KLCIS had a duty to act in good faith, to act in compliance with the law and the governing documents, and to deal fairly with KSBIT and its members.

120. KLCIS owed a duty of loyalty to KSBIT and its members, which was breached.

121. KLCIS engaged in self-dealing and used its position to benefit itself at the expense of KSBIT and KSBIT's members.

122. KLCIS failed to manage the affairs of the KSBIT Funds in the best interests of KSBIT and KSBIT's members.

123. KLCIS failed to act in good faith.

124. KLCIS's filing of the Declaratory Judgment Action, in conjunction with KLC and the KSBIT Board of Trustees, against the Department of Insurance, was an express action directly contrary to the interests of the KSBIT Funds and KSBIT's members.

125. As a direct and proximate result of the KLCIS's breach of its fiduciary obligations, the KSBIT Funds and KSBIT's members have been damaged in an amount to be proven at trial.

COUNT X– KLC AND KLCIS VIOLATIONS OF KRS 304.12-040

126. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

127. KLC and KLCIS violated KRS 304.12- 040 by preparing, filing, and providing to the KSBIT group members, deceptive, unfair and misleading financial statements which misrepresented the true financial condition of KSBIT and which grossly and materially understated KSBIT's liabilities.

128. The above-referenced statutes were enacted for the benefit of KSBIT, the KSBIT Funds, and KSBIT's members, among others.

129. The KSBIT Funds and KSBIT's members have been damaged in an amount to be shown at trial as a direct and proximate result of the statutory violations alleged in this Count.

COUNT XI – UNJUST ENRICHMENT AGAINST KSBA

130. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

131. This is a cause of action against KSBA for unjust enrichment.

132. KSBA controlled, sponsored or approved the governance and management of KSBIT and thus is responsible for the mismanagement of KSBIT.

133. According to sworn testimony from Steven Smith, a certified public accountant who is currently the CFO for KSBA, KSBA and KLC were "partners ... in terms of the operations" of KSBIT.

134. KSBA promoted KSBIT as "KSBA's Insurance and Safety Solution."

135. Based upon information and belief, KSBA knew or should have been aware of the financial problems faced or to be faced by the KSBIT Funds.

136. Notwithstanding this knowledge, KSBA continued to use participation in the KSBIT Funds as a means of securing (and increasing) membership in its association.

137. KSBIT paid royalties to KSBA based on a percentage of premiums.

138. For example, KSBIT paid approximately $296,000 in "royalties" to KSBA for 2003, and approximately $297,000 for 2004.

139. According to sworn testimony from Smith, these royalties were paid to KSBA merely for the "use of the association's name."

140. Upon information and belief, KSBIT has paid approximately $7,000,000 to KSBA over the years in royalties and endorsement fees.

141. KSBA solicited KSBIT members and school districts to support the KSBIT Funds, despite knowing the Funds' poor financial condition.

142. KSBA caused royalties and/or endorsement fees to be paid by KSBIT, which royalties and/or fees, upon information and belief, were paid by KSBIT pursuant to an unwritten agreement. To the extent such fees were improper, KSBA was unjustly enriched.

143. KSBA received a benefit in the form of royalties and/or endorsement fees all to the detriment of KSBIT's members.

144. The KSBIT Funds and KSBIT's members have been damaged by the transfer of royalties and/or endorsement fees to KSBA. All such membership and/or endorsements fees are unjust enrichment to KSBA and, accordingly, such fees should be disgorged to KSBIT and its members.

COUNT XII – NEGLIGENCE OF KSBA

145. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

146. KSBA controlled, sponsored or approved the governance and management of KSBIT and was responsible for the management of KSBIT, including the KSBIT Funds.

147. KSBA owed a duty to KSBIT and to KSBIT's members to administer and manage the business affairs of KSBIT and the KSBIT Funds.

148. KSBA breached its duty to KSBIT, the KSBIT Funds, and KSBIT's members.

149. As a result of the KSBA's negligence, the members of KSBIT and the KSBIT Funds have been damaged in an amount to be proven at trial.

COUNT XIII – NEGLIGENT MISREPRESENTATION AGAINST KSBA

150. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates herein by reference each preceding paragraph this Complaint.

151. KSBA owed KSBIT's members a duty, *inter alia*, to provide accurate information about the KSBIT Funds.

152. KSBA breached this duty by negligently making false and misleading statements and omissions upon which KSBIT members directly or indirectly relied, and which reliance resulted in significant economic losses.

153. As a result of KSBA's negligent misrepresentation, KSBIT and KSBIT's members have been damaged in an amount to be proven at trial.

COUNT XIV – ATTORNEYS' FEES

154. Pursuant to CR 10.03, Plaintiff states, reiterates and incorporates by reference each of the preceding paragraphs of this Complaint.

155. Pursuant to KRS 304.33-060, Plaintiff is entitled to recover all costs and expenses, including, but not limited to, attorneys' fees, incurred in pursuing this litigation against Defendants, without regard to any limitations otherwise prescribed by law.

WHEREFORE, Plaintiff demands as follows:

1. Judgment against Defendants jointly and severally for monetary damages in an amount in excess of this Court's jurisdictional limits;

2. the recovery from Defendants of all administrative costs incurred as a result of the necessary rehabilitation proceedings;

3. any and all equitable relief to which Plaintiff may appear properly entitled;

4. attorneys' fees and all costs herein expended;

5. all appropriate interest;

6. trial by jury on all issues so triable; and,

7. all further relief to which Plaintiff may appear entitled.

Respectfully submitted,

Signature on file with original document

Paul C. Harnice
Sarah J. Bishop
STOLL KEENON OGDEN PLLC
201 West Main Street, Suite A
P.O. Box 5130
Frankfort, Kentucky 40601
Telephone: (502) 875-6220
Facsimile: (502) 875-6235
E-mail: paul.harnice@skofirm.com

Perry M. Bentley
STOLL KEENON OGDEN PLLC
300 West Vine Street, Suite 2100
Lexington, Kentucky 40507
Telephone: (502) 231-3000
Facsimile: (502) 253-1093
E-mail: perry.bentley@skofirm.com

Justin D. Clark
STOLL KEENON OGDEN PLLC
2000 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202

Telephone: (502) 333-6000
Facsimile: (502) 333-6099
E-mail: justin.clark@skofirm.com

and

Peter F. Ervin
PUBLIC PROTECTION CABINET
OFFICE OF LEGAL SERVICES
Capitol Tower Plaza
500 Mero Street, 5th Floor
Frankfort, Kentucky 40601
Telephone: (502)
E-mail: peter.ervin@ky.gov

118121.149238/4299097.1