

STATE OF INDIANA )  
 )  
COUNTY OF MARION )

IN THE MARION SUPERIOR/CIRCUIT COURT  
CAUSE NO.: \_\_\_\_\_

49D07 09 08 CT 0 4 0 0 0 6

EDWARD P. SULLIVAN, as Trustee of the  
I.S.T.A. Insurance Trust,

Plaintiff,

v.

WARREN L. WILLIAMS, DAVID M.  
KARANDOS, UBS FINANCIAL SERVICES,  
INC., MORGAN STANLEY & CO., INC.,  
ROBERT FRANKEL, HUTTLESTON  
ASSOCIATES, INC., MCINNES MAGGART  
CONSULTING GROUP, L.L.C., and  
CROWE HORWATH, LLP,

Defendants.

**FILED**

(202) AUG 27 2009

*Elizabeth d. White*  
CLERK OF THE MARION CIRCUIT COURT

## COMPLAINT AND JURY DEMAND

### Introduction

1. This action is brought by the Trustee of the I.S.T.A. Insurance Trust (the "Trust") to recover losses sustained by the Trust because of the inappropriate investment of its assets and other serious mismanagement of the Trust and by its former fiduciaries, investment advisors, and other professionals, whose acts and omissions have brought the Trust to the brink of insolvency. Plaintiff seeks recovery on behalf of the Trust of the losses sustained by it as a result of defendants' breach of trust and breach of fiduciary duty, fraud, negligence, malpractice, and breach of contract.

AUG 31 2009

## Parties

2. Plaintiff Edward P. Sullivan is, and has been since June 2, 2009, the sole Trustee of the Trust. Since May 16, 2009, Sullivan has also served as trustee of the Indiana State Teachers Association, Inc. ("ISTA"), which is the settlor of the Trust. Sullivan was appointed as ISTA trustee by ISTA's national affiliate, the National Education Association ("NEA"), pursuant to NEA's By-Laws. Sullivan brings this action on behalf of the Trust. Sullivan's place of business as Trustee of the Trust is in Marion County.

3. Defendant Warren L. Williams was Executive Director of ISTA from 1984 until his resignation on May 14, 2009. As ISTA Executive Director, Williams served *ex officio* as a Trustee of the Trust. In 2002 Williams also became Chief Executive Officer of the Trust. He was specifically responsible for day-to-day oversight of the Trust's assets, and was the primary contact between the Trust and its investment advisors. As Trustee and as CEO of the Trust, Williams had a fiduciary relationship with the Trust. Williams is a resident of Hamilton County.

4. Defendant David M. Karandos was the Trust's investment advisor from 1994 until June 2009. Karandos was employed by defendant UBS Financial Services, Inc. from 2003 until February 2008, at which time he left UBS and became a Senior Vice President at defendant Morgan Stanley & Co., Inc. As the Trust's investment advisor, Karandos analyzed the Trust's investment goals, risk tolerance, and liquidity requirements, drafted investment policies, and retained or recommended investment managers. Karandos had a fiduciary relationship with the Trust. Karandos is a resident of Marion County.

5. Defendant UBS Financial Services, Inc. ("UBS") is a Delaware corporation with its principal office in the State of New Jersey, which does business in Indiana. UBS served with its employee Karandos as the Trust's investment advisor until February 2008, and it continued to

manage and serve as custodian of certain of the Trust's investments thereafter. UBS had a fiduciary relationship with the Trust. UBS' office in Marion County is its principal office in the State of Indiana and the office out of which the claims asserted herein arose.

6. Defendant Morgan Stanley & Co., Inc. ("Morgan Stanley") is a Delaware corporation with its principal office in the State of New York, which does business in Indiana. Morgan Stanley served with its employee Karandos as the Trust's investment advisor beginning in February 2008, and as such had a fiduciary relationship with the Trust. Morgan Stanley's office in Marion County is its principal office in the State of Indiana and the office out of which the claims asserted herein arose.

7. Defendant Robert Frankel served, from 2002 until his resignation on April 2, 2009, as Director of the ISTA Financial Services Program ("FSP") – the trade name for the financial products and services provided through several entities affiliated with ISTA. Pursuant to the Trust's Bylaws, the FSP Director serves *ex officio* as Director of the Trust. As Director of the Trust, Frankel was the named fiduciary of the Trust and was responsible for the administration of the Trust. Frankel is a resident of Hamilton County.

8. Defendant Huttleston Associates, Inc. ("Huttleston Associates" or "Huttleston") is a Wisconsin corporation with its principal offices in Madison, Wisconsin, which does business in Indiana. Continuously since at least 1989, Huttleston Associates served as the Trust's actuarial consultant. Huttleston Associates was responsible for designing the prototypes for the long-term disability programs adopted by participating Indiana school corporations and funded through the Trust (the "LTD Programs"), for creating the actuarial basis for and advising the Trust on the contribution rates that would be necessary to fund the LTD Programs adequately, for determining whether the Trust maintained sufficient reserves to fund future benefit obligations

under the LTD Programs, and otherwise for providing opinions as to the Trust's actuarial solvency with regard to the programs it was funding. An affiliate of Huttleston Associates, Huttleston Benefit Group, has provided third-party administration services to the Trust continuously since at least 1989.

9. Defendant McInnes Maggart Consulting Group, L.L.C. ("McInnes Maggart") is a Kansas corporation with its principal offices in Mission, Kansas, which does business in Indiana. Continuously from the late 1980s until 2009, McInnes Maggart (previously known as McInnes Consulting Group, L.L.C.) or its principal, Dennis Maggart, was an insurance consultant for the Trust with respect to the medical insurance programs adopted by participating Indiana school corporations and funded through the Trust (the "Medical Programs"). McInnes Maggart or Dennis Maggart designed the Trust's Medical Programs and was responsible for advising the Trust with respect to design changes, underwriting, and reinsurance issues, and for procuring reinsurance policies with respect to the Medical Programs.

10. Defendant Crowe Horwath, LLP ("Crowe Horwath") is a limited liability partnership, headquartered in Oak Brook, Illinois, which does business in Indiana. Crowe Horwath – which previously operated under the name Crowe Chizek and Company LLC – is a public accounting and consulting firm. Continuously since at least 1990, Crowe Horwath has served as the Trust's auditor. Crowe Horwath's office in Marion County is its principal office in the State of Indiana and the office out of which the claims asserted herein arose.

### **Facts**

#### **The Trust**

11. The Trust is a common law trust, established in 1985 by ISTA, a labor organization that through its local affiliates represents, in collective bargaining, teachers and

other employees of Indiana school corporations. Since its establishment, the Trust designed and managed defined-benefit welfare programs – principally the Medical Programs and the LTD Programs – that Indiana school corporations adopted as benefit plans for their employees.

12. A copy of the Amendment and Restatement of the Agreement and Declaration of Trust Establishing I.S.T.A. Insurance Trust (“Trust Agreement”) is attached hereto as Exhibit A.

13. Participation agreements between the school corporations and the Trust specified the contributions school corporations were obligated to make. In exchange, the Trust would make Trust assets available to pay benefits to school corporation employees. The school corporations’ contributions were made from public revenues.

14. The benefit programs established by each of the participating school corporations and funded through the Trust were “governmental plans,” as defined in section 3(32) of the Employee Retirement Income Security Act (“ERISA”), 29 U.S.C. § 1002(32). The Trust is not itself an employee benefit plan within the meaning of ERISA, but instead served as a funding vehicle, which was authorized by the school corporations through their participation agreements to hold and invest the school corporations’ contributions.

15. Because of the events to be detailed below, the Trust was brought, by May 2009, to the point where its obligations under programs it funded far exceeded its assets, and the contributions and other income to the Trust were less than its ongoing benefit payments and other expenditures. On June 30 and July 31, 2009, respectively, the Trust ceased serving as a funding vehicle for the Medical Programs and the LTD Programs. As of those dates, it was without liquid resources to pay future benefits – with an estimated present value of at least \$34 million – to some 650 LTD claimants, or to satisfy the claims of participating school

corporations for refunds of the Trust's "claims stabilization reserves," totaling an additional estimated amount of at least \$20 million.

16. On May 16, 2009, NEA appointed plaintiff Sullivan as trustee of ISTA, in large measure to address the financial crisis that had emanated from the Trust's losses and spread to ISTA and its related organizations. Shortly thereafter, Sullivan assumed authority over the Trust as its sole Trustee. Sullivan's mandate was, with financial assistance from NEA, to ensure that the claims of LTD beneficiaries were paid, to resolve the Trust's other obligations, and to recover as much as possible of the Trust's losses through legal action against those whose acts and omissions were responsible for those losses.

#### **The Trust's Investments**

17. Defendant Karandos had been the Trust's investment advisor since 1994. Karandos was employed by Merrill Lynch until 2003, when he moved to UBS.

18. Karandos was employed by UBS and acted as its agent. In his dealings with the Trust, Karandos was acting within the scope of his authority or apparent authority. As Karandos' employer, UBS directly or indirectly controlled him and materially aided his conduct with regard to the Trust.

19. Karandos and UBS acted as the Trust's financial advisor, assisted in creating the Trust's investment policy, and recommended individual securities. Karandos and UBS were fiduciaries for the Trust. Agreements between UBS and the Trust acknowledged this fiduciary relationship.

20. A copy of the August 3, 2007 Consulting Services Agreement between UBS and the Trust is attached hereto as Exhibit B.

21. As of 2003, the Trust's investment portfolio did not contain any "alternative" investments.

22. In December 2002, following the resignation of former Trust Executive Director Bruce Rogers, Williams appointed Frankel as Director of the Trust. Williams appointed himself, however, to the newly created position of Chief Executive Officer ("CEO") of the Trust. On December 17, 2002, the Trust Agreement was amended and restated to provide for this position.

23. Although Williams delegated to Frankel responsibility for day-to-day operations of the Trust, he retained for himself, as CEO, responsibility with regard to the investment of the Trust's assets.

24. Williams and Karandos were socially close. Karandos introduced Williams' future wife to him, and the two couples sometimes vacationed together. Karandos also served as Williams' personal financial advisor.

25. In 2004, Karandos drafted a "Statement of Investment Policy" for consideration by the Trust's Board of Trustees. The policy provided that "[t]he [Trust's] assets shall be invested in accordance with sound investment practices that emphasize long-term investment fundamentals," and it recognized that the Trust required liquidity in its investments, because the Trust depended on its assets for operating income. Nonetheless, the policy established an aggressive investment policy that included "alternative investments" (defined as managed futures and hedge funds). The policy provided, however, that alternative investments were to be limited to a maximum of 20% of the market value of the Trust. In addition, the investment policy prohibited investment in private placements, *i.e.*, securities not traded on a public exchange.

26. The investment policy was adopted by the Trust's Board of Trustees on February 27, 2004, subject to certain editorial changes that were incorporated in the final document dated

April 30, 2004. The investment policy was signed by Williams on behalf of the Board of Trustees on May 7, 2004.

27. The Trustees' statement of approval of the policy provided: "Should the Trustees permit a deviation from this policy or implement a change in policy, the circumstances and rationale for the change shall be documented and attached to this investment policy."

28. Both Williams and Karandos were aware that Williams had no authority to deviate or approve deviations from the investment policy without authorization of the Board of Trustees.

29. The Trustees never approved any deviation from the 2004 investment policy, which remained in effect without change until October 2008.

30. In or about September 2005, Karandos and Williams began to invest the Trust's assets in private placements.

31. As both Karandos and Williams knew or should have known, this investment of the Trust's assets was in violation of the investment policy that had been adopted by the Board of Trustees the year before.

32. This deviation from the investment policy and the investments in private placements were undertaken without authorization of the Board of Trustees.

33. The investments in private placements were undertaken without explanation or sufficient explanation to the Trustees of the risks associated with the private equities and other alternative investments, including but not limited to their lack of liquidity and exposure to huge capital calls.

34. Nor was the Trust's legal counsel consulted about the fiduciary and tax implications that could flow from this purchase of private placements and other alternative investments.

35. By August 2007, Karandos and Williams had invested a total of approximately \$19.5 million – or half of the Trust's total assets – in alternative investments, including hedge funds and private placements.

36. At the end of 2008, the Trust's holdings in private placements alone amounted to nearly \$16.4 million – more than 78% of its total assets. Private placements and other alternative investments combined constituted over 87% of the Trust's total assets.

37. These investments far exceeded the 20% limit on alternative investments contained in the Trust's 2004 investment policy. In addition, the private placements were in violation of the policy's prohibition of such investments.

38. As both Williams and Karandos knew or should have known, such investments are highly inappropriate for an employee benefit trust that funds health insurance claims, because of their risk and lack of liquidity.

39. The private equities purchased by Karandos for the Trust were, as a consultant to the Indiana Department of Insurance ("IDOI") determined, "dramatically illiquid." Indeed, according to UBS itself, "[p]rivate investment securities and structured products generally are highly illiquid."

40. Because of the lack of liquidity and level of risk associated with such investments, the United States Government Accountability Office ("GAO"), in an August 2008 report entitled "Defined Pension Benefit Plans, Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity," warned defined benefit pension plans

about the risks of such investments. According to a survey GAO had conducted, such plans typically invested no more than 4-5% of their assets in hedge funds and private placements.

41. That warning is even more apt with respect to defined-benefit welfare funds, like the Trust's fund. Unlike defined-benefit pension funds, whose obligations to pay claims come due at a time well into the future, defined-benefit welfare funds have immediate obligations, so that the need for liquidity in investments is an even more serious consideration.

42. Most or all of the private equities that Karandos purchased for the Trust were UBS proprietary products.

43. On information and belief, Karandos received greater compensation by placing assets in alternative investments than in common stocks, bonds, and mutual funds.

44. In February 2008, Karandos moved from UBS to Morgan Stanley. After that date, Karandos was employed by Morgan Stanley and acted as its agent. In his dealings with the Trust, Karandos was acting within the scope of his authority or apparent authority. As Karandos' employer, Morgan Stanley directly or indirectly controlled him and materially aided his conduct with regard to the Trust.

45. Karandos and Morgan Stanley, along with UBS, thereafter acted as the Trust's financial advisor, assisted in creating the Trust's investment policy, and recommended individual securities, and as such were fiduciaries for the Trust.

46. A copy of the March 14, 2008 Institutional Consulting Agreement between Morgan Stanley and the Trust is attached hereto as Exhibit C.

47. After his move to Morgan Stanley, Karandos prepared and provided to Williams or Frankel a ranking of the Trust's private equity holdings, in which Karandos made recommendations with regard to the private equities.

48. In a “consolidated portfolio review” prepared for the Trust in May 2008, Karandos and Morgan Stanley reported that over \$21.6 million of the Trust’s \$23 million in assets – or 93.91% – were invested in “alternative strategies.” On information and belief, Karandos and Morgan Stanley failed to advise the Trust that such huge exposure to risky and illiquid investments was inappropriate and dangerous and that the Trust should promptly move to reduce its holdings of such investments in an orderly fashion.

49. During the fall of 2008, the Trust required significant amounts of cash in order to pay current claims. Because of the Trust’s lack of liquid assets, it was forced to sell some of its private placements at substantial losses, in many cases for less than half their value. The IDOI consultant’s analysis in the spring of 2009 valued the Trust’s remaining alternative investments at only 25% of their cost.

50. The Trust’s private equity holdings required the Trust to pay several capital calls, in the amount of at least \$7.5 million.

51. Because the Trust’s private equity investments were in UBS proprietary products, they could not be transferred to Morgan Stanley along with the rest of the Trust’s investment portfolio, but rather remained under UBS management. The Trust was required to continue to pay UBS a fee for managing these assets.

52. During the fall of 2008, after Karandos had joined Morgan Stanley, and while the Trust was in the process of liquidating many of the private placements in which Karandos had invested its assets – incurring significant losses as a result – Karandos complained to Williams about the compensation he received from the Trust, which had fallen because it was defined as a percentage of the Trust’s portfolio value. Notwithstanding the catastrophic results of Karandos’ stewardship of the Trust’s investment portfolio, Williams agreed to restate Karandos’

compensation as a flat fee, with the result that his rate of annual compensation in 2008 doubled in the subsequent months.

53. By paying Karandos and Morgan Stanley, as well as UBS, for managing its investments with UBS, the Trust was paying more than reasonable compensation for the management of its investment portfolio.

54. Karandos and Morgan Stanley continued to provide investment services to the Trust until at least June 2009, while UBS continued to manage and serve as custodian of the Trust's alternative investments and private placements.

55. As a result of the acts alleged above, the Trust's investments lost substantial value, while at the same time the Trust could not access its remaining assets invested in private placements because of liquidity restrictions.

56. The Trust's imprudent investments left it without the liquidity to address the problems in its benefit programs, detailed below, that came to a head in 2008 and 2009.

### **The LTD Programs**

57. From its inception in 1985 until 1989, the LTD Programs were fully insured by American Fidelity, through one or more policies procured by the Trust.

58. Beginning in 1989, the LTD Programs became self-insured, that is, the benefits under the LTD Programs were secured only by the assets of the Trust. As it underwrote the risk for the LTD Programs, the Trust was required to determine the premiums, charged to the school corporations, that would provide sufficient revenues to cover the payments to beneficiaries for which the Trust would be liable, as well as any associated administrative costs.

59. In setting such premiums, an actuary must establish a pricing regime that will yield revenues sufficient to: (i) pay the anticipated future beneficiary claims and associated

