

On Top of Increasing Legal Expenses, Private Equity Faces Litigation Risk from Pension Funds and State AGs, Experts Say

Pension funds that for years believed private equity firms could help deliver outsized returns for retirees are now contemplating whether they can sue as investments are falling flat, giving private equity giants a legal headache at a time when markets are increasingly volatile.

Pension funds are not just grouching about poor returns. Some claim that private equity firms are trying to tie up pensions' investments for longer than agreed. Others say private equity firms are reluctant to refund high fees under previously agreed "clawback" provisions, even when returns are not meeting the hurdle or performance level arranged at the start of the investment.

The threat of lawsuits creates a risk for PE firms that are already facing higher administrative costs and are struggling to sell their portfolio companies in public markets at a time of general economic uncertainty. "There's a major log jam of portfolio companies that private equity firms are unable to exit," said Alyssa Giachino, investor engagement director at Private Equity Stakeholder Project.

As interest rates remain high and tariff discussions inject further volatility into the stock market, it is not clear when private equity firms will have the cash they need to return to some of their largest investors: U.S. pensions. "Private equity has been saying for multiple quarters that they were quite certain that the log jam was going to loosen up right on the horizon, and that horizon keeps stretching further and further out of reach," said Giachino.

When Private Equity could point to outsized returns for investors, it was easier for pensions to set aside concerns about these funds' illiquidity, lack of transparency, high fees and lack of governance rights. "The current conditions are really testing that philosophy, because private equity returns have been quite mediocre for the past few years," said Giachino.

Most of the legal wrangling between private equity firms and their pension fund investors is happening behind closed doors, rather than in public courtrooms. But evidence of this emerging friction is showing up in the form of greater legal costs, both in the quarterly statements of publicly-listed private equity firms and in public pensions' reports to members.

"Private markets consistently has the highest number of legal compliance matters," Denise Lopez, director of legal and compliance at Teacher Retirement System of Texas, told the system's board in April. A spokesman for TRS, which is one of the largest U.S. pensions with more than \$200 billion in assets, declined to comment about the kinds of matters Lopez's team addresses.

TRS has \$32 billion invested in private equity and has seen that portfolio's performance stagnate, returning an average 2.7% over the last three years through December and missing its benchmark. Private equity firms are also reporting higher legal costs, which analysts said is reflected in the increase in a line item on their operating statement each quarter. Blackstone (BX) reported its general, administrative and other costs rose to \$1.36 billion last year, up from \$1.12 billion in 2023. KKR (KKR) saw its general, administrative and other costs climb to a similar \$1.31 billion from \$1.06 billion in 2023.

Pensions are often limited partners in private equity funds with the right to claw back fees that general partners—the private equity firms' managers—pay to themselves from fund distributions known as “carried interest”. One out of every 14 private equity funds launched between 2012 and 2015 could be at risk of a clawback, [reported](#) investment firm Upwelling Capital last year. The firm, which advises institutional investors including pensions on private equity investments, found that about \$27.8 billion of private equity money could be clawed back by investors.

The challenge for private equity firms is that as liquidity remains tight and they are unable to sell portfolio companies close to their valuations, they may not have enough cash to pay back fees. This is a financial risk that publicly-listed private equity firms warn investors about in their annual reports.

Kentucky case blazes legal trail. Plaintiff attempts to take on private equity funds over fees have had mixed results, but a recent \$275 million [settlement](#) in a years-long battle between Kentucky and funds including private equity firms KKR and The Blackstone Group may draw attention from other state attorney generals.

J.J. Conway, a Michigan-based lawyer focused on pension topics, said the settlement figure is significantly higher than the average settlement in a privately-sponsored pension case involving claims of excessive fees or investment mismanagement. “The figures involved in this settlement might encourage other state attorney generals to look at their own statutes and bring cases to shore up pension plan underfunding and losses,” Conway said.

Last month, Kentucky circuit court Judge Thomas Wingate declined to approve the settlement, telling the parties it was outside of the remit of the court and they could settle as they best see fit. Declining to confirm the settlement agreement was seen as a blow to the defendants and a win for the public employees that had filed a separate suit against the asset managers.

The proposed settlement had sought to bar future class actions brought by Kentucky pension plan members, even though the defendants had already won a favorable ruling on that issue, Conway

said. The defendants may have seen this as an emerging and unsettled area of the law, and they may have wanted to try to discourage further claims, he added.

Some state pensions have started selling off private equity investments into an emerging secondary market for the funds, as a way to reduce their exposure to the underperforming asset class. Pennsylvania State Employees' Retirement System (SERS) has [sold off about](#) \$2 billion of its private equity portfolio in the last six months.

State Treasurer Stacy Garrity said that selling off these investments would not prevent her from acting to recoup fees, however. "As a fiduciary, the Treasurer would support any effort to recapture unwarranted fees," Garrity's office wrote in an email to *The Capitol Forum*.