NIALL P. McCARTHY (SBN 160175)
nmccarthy@cpmlegal.com
ANNE MARIE MURPHY (SBN 202540)
amurphy@cpmlegal.com
ERIC J. BUESCHER (SBN 271323)
ebuescher@cpmlegal.com
DEMETRIUS X. LAMBRINOS (SBN 246027)
dlambrinos@cpmlegal.com
COTCHETT, PITRE & McCARTHY, LLP
840 Malcolm Road
Burlingame, California 94010
Telephone: (650) 697-6000
Facsimile: (650) 692-3606

Attorneys for Plaintiffs Burton Richter, Linda Collins Cork, Georgia L. May, Thomas Merigan, Alfred Spivack, and Janice R. Anderson

IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

BURTON RICHTER, an individual; **LINDA COLLINS CORK**, an individual; **GEORGIA L. MAY**, an individual; **THOMAS MERIGAN**, an individual; **ALFRED SPIVACK**, an individual; and **JANICE R. ANDERSON**, an individual; on behalf of themselves and all others similarly situated,

Plaintiffs,

v.

CC-PALO ALTO, INC., a Delaware corporation; **CLASSIC RESIDENCE MANAGEMENT LIMITED PARTNERSHIP**, an Illinois limited partnership; and **CC-DEVELOPMENT GROUP, INC.**, a Delaware corporation,

Director Defendants.

Case No. 5:14-cv-00750-EJD

PLAINTIFFS' OPPOSITION TO DIRECTOR DEFENDANTS' MOTION TO DISMISS FIRST AMENDED COMPLAINT

Date: May 14, 2015
Time: 9:00 a.m.
Courtroom: 4, 5th Floor
Judge: Hon. Edward J. Davila

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

I. INTRODUCTION

Plaintiffs are residents of the Vi at Palo Alto, which is operated by Defendant CC-Palo Alto, Inc. ("CC-PA") and its parent company Defendant CC-Development Group, Inc. ("CC-DG"), and a related entity Defendant Classic Residence Management Limited Partnership. CC-PA and CC-DG are both Delaware corporations. Each Plaintiff loaned CC-PA a substantial amount of money in the form of an Entrance Fee, which CC-PA is obligated to repay to Plaintiffs. Plaintiffs are thus creditors of CC-PA. Contrary to promises made to Plaintiffs—and contrary to California law regulating Continuing Care Retirement Communities ("CCRCs"), CC-PA kept no cash reserves[1] to cover its obligation to Plaintiffs and the Class – instead it upstreamed hundreds of millions of dollars of entrance fee loan proceeds to CC-DG. CC-DG has disclaimed any obligation to repay the entrance fee loans, or to fund repayment of the entrance fee loans to Plaintiffs. As a result of the upstreaming CC-PA is insolvent. CC-PA's insolvency has been acknowledged by a third-party, professional actuary and the State of California.

As Director Defendants acknowledge, under Delaware law, if a corporation becomes insolvent, its creditors have standing to assert a derivative breach of fiduciary duty claim against its board of directors. Plaintiffs' First Amended Complaint ("FAC") asserts such derivative claims against six former and current members of CC-PA's board of directors. These directors are responsible for allowing the illegal dividends to CC-DG that have materially contributed to CC-PA's insolvency and impaired CC-PA's ability to repay entrance fee loans to the residents of the Vi at Palo Alto.[2]

[1] The only exception is that CC-PA established a reserve for refunds of Entrance Fees for residents entering the Community after June 1, 2012. However, these reserves represent only approximately 6% of the entrance fee refunds due to these residents; do not comply with California law; and do not cover the rest of the residents at all.

[2] These Defendants are referred to in the FAC, as well as this brief, as the "Director Defendants" and include the following six individuals: Penny Pritzker, Nicholas Pritzker, John Poorman, Gary Smith, Stephanie Fields, and Bill Sciortino. Each of Director Defendants' backgrounds with CC-PA is described in the FAC. *See* FAC ¶¶ 38-45. Further, details of their involvement in the financial management of CC-PA, and their actions to benefit CC-DG at the expense of CC-PA, and their actions to reject Plaintiffs' attempts to remedy the financial improprieties are catalogued in the FAC. *See* FAC ¶¶ 106-11, 156-184.

Director Defendants' primary argument is that CC-PA is not really insolvent because they claim that a balance sheet deficit alone is insufficient to show insolvency under Delaware case law; however, the cases Director Defendants cite are distinguishable. In addition, CC-PA has more than a mere balance sheet deficit, it has a deficit of over $310 million, and an outside auditor found that CC-PA "does not possess sufficient resources for current residents (including the actuarial present value of periodic fees expected to be paid in the future by present residents) to cover the actuarial present value of the expected costs of performing all remaining obligations to such residents under their contracts." FAC Ex. 4 at p. 5 (emphasis added).

Director Defendants' other main argument is that Plaintiffs cannot sue on a class and derivative basis because it creates a conflict of interest; as discussed below, controlling Ninth Circuit precedent holds otherwise. Whether couched as a class claim, or as a derivative claim, both approaches seek the exact same thing, which is the return of the funds that were unlawfully upstreamed to CC-DG. FAC ¶ 10. It is well established that the election between a derivative and class claim need not be made at the pleading stage. *In re RasterOps Corp. Sec. Litig.*, No. C 92-20115 RMW EAI, 1993 U.S. Dist. LEXIS 21504, at *23 (N.D. Cal. Sept. 9, 1993).[3]

II. FACTUAL AND PROCEDURAL BACKGROUND

The Vi at Palo Alto is a CCRC. FAC ¶ 1. The proposed class consists of all individuals who have resided at the Vi at Palo Alto between January 1, 2005 and the present. *Id.* ¶ 1. Prior to entering the Vi at Palo Alto, Plaintiffs and the Class entered into Continuing Care Residency Contracts ("Residency Contracts"), and loaned over $460 million to CC-PA, from hundreds of thousands, to millions of dollars per resident, in the form of refundable Entrance Fees. *Id.* ¶¶ 4-5. Plaintiffs and the Class also pay large monthly fees to reside at the Vi at Palo Alto. *Id.* ¶¶ 10-14.

[3] Plaintiffs are simultaneously filing an Opposition to Corporate Defendants' Motion to Dismiss, which primarily concerns the direct (class) claims. The Pritzker Motion and Corporate Defendants' Motions do overlap. Plaintiffs have tried to avoid duplicating arguments between their Oppositions and incorporate by reference their Opposition to the Corporate Defendants' Motion.

CC-PA distributed marketing materials that suggested to prospective residents that the Entrance Fees would be used to provide services—which was false since CC-PA has not used the Entrance Fees to provide services, rather it has upstreamed the money to CC-DG:

> ***Why is there an entrance fee? What does it cover?***
> To have the financial resources needed to operate as a CCRC, retirement communities in California typically need to charge an entrance fee and a monthly fee. The fees cover independent living; services such as dining, housekeeping, 24-hour concierge service, and maintenance of the grounds and homes; access to community amenities; and the benefits of the continuing care program.
>
> ***Why is there an entrance fee for a second person?***
> An additional entrance fee is charged for a second person to help cover the cost of services and continuing care benefits for that person.

FAC ¶ 91, Ex. 26.

CC-PA breached the Residency Contracts and impaired Plaintiffs' security for their entrance fee loans by illegally upstreaming hundreds of millions of dollars to CC-PA's parent company CC-DG. *Id*. ¶¶ 11, 21, 90-96. CC-PA concealed these, and other important facts, from Plaintiffs. *Id*. ¶¶ 201, 246. CC-PA also made false assurances regarding the security of Plaintiffs' Entrance Fees:

> [Residents experience] a sense of security, knowing that they have made a good choice. They know their entrance fee refund will not fluctuate with changes in the market…. Our residents enjoy a vibrant and enriching lifestyle with the knowledge that they have planned wisely to secure their future.

Id. at Ex.18.

Plaintiffs reasonably expected that CC-PA would maintain sufficient cash reserves to pay back their Entrance Fees because California law requires it. *See* California Health & Safety Code §§ 1792.6, 1793. Since inception of the Community in 2005, CC-PA's promotional materials have acknowledged this reserve requirement:

> **The California DSS [Department of Social Services] continues to regulate the community after the release of the funds and requires the community to maintain certain cash reserves in amounts sufficient to meet State requirements.**

FAC ¶ 20 and Ex. 3 (page 3) (emphasis added).

Defendants do not dispute that they have failed to maintain sufficient cash reserves to cover the Entrance Fee refund obligations; rather, they assert that the failure to do so is not actionable. *See id*. at Ex. 6, p.1 ("there is no entrance fee repayment reserve"); *see also* Corporate Defendants Mot. at 6. Since 2005, Plaintiffs have collectively loaned CC-PA over $460 million in Entrance fees. FAC ¶ 15. As of 2013, CC-PA had upstreamed over $219 million to CC-DG, and had incurred a deficit of over $310 million. *Id*. at ¶¶ 21, 23.

At all relevant times from the first residents' entry into the Community in 2005, to the present, the CC-PA Board of Directors has never addressed: (a) CC-PA's increasing negative net worth; (b) CC-PA's inability to pay its obligations owed to residents under its outstanding Entrance Fee Notes as they matured without payments from CC-DG; (c) whether CC-PA had sufficient surplus from which to pay dividends to CC-DG; or (d) the other matters complained of in this Complaint. FAC ¶ 106.

During the period from the first residents' entry into the Community in 2005, to the present, CC-PA has never held a Board Meeting at all. In lieu of any meetings of the Board, once each year, Directors of CC-PA have taken action by unanimous written consent pertaining to the matters affecting CC-PA. From 2005 through 2011, such action by unanimous written consent of the CC-PA Board includes only boilerplate resolutions in substantially the following form:

> "FURTHER RESOLVED, that all distribution, dividend and/or capital contribution transactions between the Corporation and its stockholders that have been recorded in the books and records and tax returns of the Corporation from time to time, if any, shall be, and they are hereby, authorized, ratified, confirmed and approved for all purposes and in all respects;"
>
> "FURTHER RESOLVED, that all acts and deeds of the Chairperson, Vice Chairman, President, Vice President, Secretary, Assistant Secretary or any other officer of the Corporation taken prior to the date hereof to carry out the intent and accomplish the purpose of the foregoing resolutions are hereby approved, adopted, ratified and confirmed in all respects as the acts and deeds of the Corporation;"

See FAC ¶ 107, and Ex. 27.

Since 2011, the unanimous written consent of the CC-PA Directors has omitted the above boilerplate resolutions in favor of a shorter, simpler resolution:

> "FURTHER RESOLVED, that any document heretofore executed and any action heretofore taken by any director or proper officer of the Corporation in furtherance of the business of the Corporation otherwise permitted under or contemplated by these resolutions be, and each of them hereby is, ratified, confirmed and approved for all purposes and in all respects."

See FAC ¶ 108, and Ex. 28.

Under Section 170 of the Delaware General Corporation Law, only the Board of Directors of CC-PA is granted the authority, after having satisfied its statutory responsibilities, to declare and authorize CC-PA to pay legal dividends to CC-DG, CC-PA's sole shareholder. None of the dividends paid by CC-PA officers to CC-DG during the period from 2005 through the present day were paid by them following CC-PA's Board of Directors' consideration of the economic stability of CC-PA. FAC ¶ 109.

The above boilerplate resolutions of CC-PA's Board of Directors represent an attempt, made after the fact, to "legalize" illegal actions that had been taken by CC-PA officers to pay dividends to CC-PA without prior, legally effective action of the CC-PA Board of Directors. FAC ¶ 110. Such boilerplate resolutions after the fact of such dividend payments do not satisfy the required duty of care and the required actions of a Board of Directors to declare a valid dividend under Delaware law. The CC-PA Board's motive is transparent. As a puppet of CC-DG, to whom all of the CC-PA Directors owe their positions in the companies, the Board of Directors has favored the interests of CC-DG over the interests of CC-PA and of the residents as its primary creditors. *Id.*

In making such distributions for the sole benefit of CC-DG, and to the economic detriment of CC-PA, and in failing to comply with Sections 170, 173 and 174 of the Delaware General Corporation Law, the CC-PA Directors have violated their obligations to CC-PA and to the residents, as its creditors. Such actions and inactions of the CC-PA Board were not taken in good faith and constitute a knowing violation of law, including California Health and Safety Code Section 1792.6. FAC ¶ 111.

Each of the Director Defendants' roles and periods of service as a director is detailed in the FAC. *See* FAC ¶¶ 38-45, 106-11, 156-184. Each of them obtained their primary—if not exclusive—compensation from CC-DG. Each of them failed to prevent officers of CC-PA from

paying illegal dividends to CC-DG, and then sought to ratify such actions without satisfying their responsibilities to CC-PA under Delaware law. Each of them was acting primarily for the benefit of CC-DG and against the financial interests of CC-PA, in violation of their obligations to CC-PA.

In addition to this illegal upstreaming, Defendants have already harmed Plaintiffs and the class, and continue to do so each and every month, by charging artificially inflated monthly fees. FAC ¶¶ 24-30, 115-129. These monthly fees, which are ostensibly intended for the upkeep and improvement of the facilities at the Vi at Palo Alto, have been artificially inflated in multiple ways. First, CC-PA has stated it will pass on property taxes to the residents that were incurred solely due to CC-PA's illegal upstreaming. *Id*. ¶¶ 8, 27, and 115-123, Ex. 24.[4] That cost amount is approximately $1.9 million a year to the Class. *Id.* ¶ 117. Second, CC-PA improperly allocated charges for earthquake insurance premiums to Plaintiffs, and has indicated that in the event of damage to its buildings, it will charge any future deductible required by its earthquake policy, to plaintiffs, who are only contractually responsible for capital items within the scope of the cost of Community operations. *Id*. ¶¶ 28 and 124-127. Third, CC-PA overcharged Plaintiffs for so-called "marketing costs" that were properly CC-PA's cost of obtaining entrance fee loans. *Id*. ¶¶ 29, 128-129.[5] These overcharges have been uniformly imposed on Plaintiffs and the Class. Director Defendants' illegal upstreaming of Plaintiffs' Entrance Fees and the overcharges associated with the monthly fees give rise to the fifteen causes of action alleged in Plaintiffs' Complaint, which are each discussed in more detail in this Opposition to Director Defendants' Motion to Dismiss (the "Pritzker Motion") and in the Opposition to the Corporate Defendants' Motion to Dismiss, which is incorporated by reference herein.

[4] In fact, CC-PA has already passed on some of these taxes by electing to suspend credits that were due to Plaintiffs as "Cumulative Operating Surplus," and which should have been used to create an operating reserve at the Vi at Palo Alto or remitted to the Plaintiffs as lower monthly fees. *Id*. ¶ 119.

[5] *See* Opposition to Corporate Defendants' Motion § IV.B.7.

For ease of reference the fifteen causes of action are as follows:

COUNT	ALLEGED AGAINST	DERIVITIVE OR CLASS CLAIM
1. Financial Abuse of Elders	All Defendants	Direct/Class Claim
2. Concealment	All Defendants	Direct/Class Claim
3. Negligent Misrepresentation	All Defendants	Direct/Class Claim
4. Breach of Fiduciary Duty / Constructive Trust	All Defendants	Direct/Class Claim
5. Violations of California Civil Code § 1750 *et seq.*	All Defendants	Direct/Class Claim
6. Violation of California B&P Code § 17200 *et seq*. – Restitution and Disgorgement	All Defendants	Direct/Class Claim
7. Violation of California B&P Code § 17200 *et seq*. – Injunctive Relief	All Defendants	Direct/Class Claim
8. Breach of Contract	CC-PA	Direct/Class Claim
9. Breach of the Implied Covenant	CC-PA	Direct/Class Claim
10. Declaratory Relief	All Defendants	Direct/Class Claim
11. Creditor Claim for Breach of Fiduciary Duties	Director Defendants	Derivative Claim
12. Creditor Claim for Breach of Fiduciary Duties or in the Alternative Aiding and Abetting Director Defendants' Breaches	CC-DG	Derivative Claim
13. Payment of Unlawful Dividends	Director Defendants	Derivative Claim
14. Fraudulent Transfer of Assets	CC-DG	Derivative Claim
15. Corporate Waste	Director Defendants	Derivative Claim

As explained herein, Director Defendants' motions should be denied.

III. ARGUMENT

A. Court Has Subject Matter Jurisdiction

Director Defendants admit that "[u]nder controlling Delaware law, 'equitable considerations' give creditors of a corporation standing to pursue derivative claims, but only

when the company is insolvent." Pritzker Motion 3:2-3. The Parties are in agreement on this point. Although the case is not named in the Pritzker Motion, a key Delaware case on the issue of creditor derivative claims is *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014). *Quadrant* was decided by the Court of Chancery of Delaware on October 1, 2014—two months before the FAC was filed in this case. *Quadrant* chronicles the evolution of creditor derivative breach of fiduciary duty claims in Delaware. *Id.* at 172-176. *Quadrant* discusses at length a number of the cases cited by Director Defendants including *N. Am Catholic Educ. Programming Found. Inc. v. Gheewala* (*Gheewala*), 930 A. 2d 92, discussed *infra*.

As the *Quadrant* court explained:

> As residual claimants and the ultimate beneficiaries of the fiduciary duties that directors owe to the corporation, stockholders have standing in equity to bring claims derivatively on behalf of the corporation for injury that the corporation has suffered. When a corporation is insolvent, its creditors become the beneficiaries of any initial increase in the corporation's value. The stockholders remain residual claimants, but they can benefit from increases in the corporation's value only after the more senior claims of the corporation's creditors have been satisfied. **The corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value. Because the creditors of an insolvent corporation join the class of residual claimants, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation.**

Id. at 172 (internal quotations and citations omitted) (emphasis added). Having made a large entrance fee loan to CC-PA, each of the Plaintiffs in this action is a creditor of CC-PA. *See* FAC ¶¶ 15, 54, 57, 60, 63, 67, and 70. Thus, the next step of the analysis is whether CC-PA is insolvent.[6]

B. <u>Plaintiffs Have Sufficiently Alleged That CC-PA Is Insolvent</u>

Determining whether a company is insolvent requires fact intensive analysis that is not appropriate at the pleading stage. As discussed in *Quadrant*:

> After *Gheewalla*, actual insolvency is the relevant transitional moment. Of course, the point at which a corporation becomes insolvent remains

[6] Plaintiffs' Article III standing and ripeness arguments are laid out in their Opposition to the Motion to Dismiss brought by the corporate Defendants, as both Motions to Dismiss cite the same cases. This brief focuses on the standing requirements for creditor derivative claims under Delaware law.

> debatable, is difficult to perceive in real-time, and can only be determined definitively by a court in hindsight.

Id. at 174. The *Quadrant* Court continued with a discussion of the two approaches to determining insolvency under Delaware law—the "balance sheet" and the "cash flow" tests:

> Under *Gheewalla*, Quadrant gains standing to bring a derivative claim by pleading that the Company is insolvent. A plaintiff can plead insolvency through allegations that meet either the "balance sheet" test or the "cash flow" test. Under the balance sheet test, an entity is insolvent if it has liabilities in excess of a reasonable market value of assets held. In a mature company, the existence of a great disparity between assets and liabilities . . . at least raises an issue of material fact as to whether the company was insolvent sufficient to survive a motion to dismiss.
>
> . . .
>
> Focusing on the September 2011 Financials, the Complaint alleges that the Company had $600 million of outstanding bond debt and assets with a fair saleable value of only $426 million.
>
> . . .
>
> These facts adequately plead insolvency under the balance sheet test. The defendants have sought on several occasions to introduce material outside of the Complaint which they say defeats the pleading-stage inference of insolvency. For the court to consider these submissions would require converting the motion to dismiss into a motion for summary judgment. They have not been considered.

Id. 176-177 (internal citations and quotations omitted).

That the company in *Quadrant* was a mature one is relevant to the instant case because CC-PA is "mature"; its startup phase is long over. This is in contrast to "startup" companies, where an initial imbalance between assets and liabilities may be necessary to launch the business. Two of the cases Director Defendants cite to support their argument that it is common for a Delaware corporation to operate with liabilities in excess of its assets, involve companies that the Courts viewed as being in a startup phase, a status the courts deemed relevant to the issue of solvency. *See Francotyp-Postalia Ag & Co. v. On Target Tech*., 1998 Del. Ch. LEXIS 234 (Del. Ch. Dec. 24, 1998) (cited in Pritzker Mot. at 7:22-8:5, 9:15-10:5); *see also, Teleglobe USA, Inc. v. BCE Inc.* (*In re Teleglobe Communs. Corp.*), 392 B.R. 561, 601 (Bankr. D. Del. 2008) (cited in Pritzker Mot. at 10:15-11:11:9). Unlike the startup companies whose insolvency was at issue in the cases above, the insolvency brought about by CC-PA's extravagant upstream distributions to CC-DG served no legitimate corporate purpose.

The FAC contains ample evidence of CC-PA's insolvency. As alleged in the FAC, at all relevant times since CC-PA admitted the first residents to the Community in 2005, CC-PA's liabilities have exceeded the reasonable market value of its assets, and according to CC-PA's audited year-end financial statements, its "Total Stockholder's Deficit" (*i.e.*, negative net worth) has increased from ($106,317,195) on December 31, 2005 to ($310,105,928) on December 31, 2013. FAC ¶ 99. At the same time, during the period from 2005 through December 31, 2013, CC-PA's repayment obligations to residents entering the Community under CC-PA's Entrance Fee Notes have increased from approximately $307,288, 000, on December 31, 2005, to approximately $463,649,000, on December 31, 2013. *Id.*[7] Further, the ground lease between CC-PA and Stanford University is, and will remain a declining asset. *See, e.g.,* FAC Ex. 2 at p. 12 (financial statement describing ground lease).

In 2005, using Entrance Fees borrowed from entering residents, CC-PA repaid to CC-DG all of the $23,234,499 of capital that CC-DG had invested as capital in CC-PA. FAC ¶ 100. Since that time, CC-DG has never invested additional capital in CC-PA. *Id.* As the result, since 2005, following receipt of Entrance Fees from the first residents entering the Community, CC-DG has had no capital investment in CC-PA; and CC-DG – CC-PA's sole shareholder – has had no capital at risk from its ownership and operation of CC-PA. *Id.*

From 2005 through 2013, CC-PA has had no surplus within the meaning of Section 154 of the Delaware General Corporation Law, and as reflected in Sections 170 and 173. FAC ¶ 101. In each year from 2005 through 2013, CC-PA has had insufficient funds to repay its borrowing from residents in the Care Center as its obligations to such residents have matured upon death or departure of such residents. FAC ¶ 102. As the result, to enable CC-PA to pay its maturing obligations, CC-PA has had no choice but to ask CC-DG for funds – convincing evidence that CC-PA is insolvent under the second test of insolvency cited in Pritzker's motion (6:28-7:1). CC-DG has voluntarily made such advances, but abjures that it has any obligation to do so in the

[7] Again, Director Defendants can take no solace from cases that provide a degree of flexibility to the test of "insolvency" when the company at issue is a startup. Here, CC-PA's finances continue to deteriorate solely to benefit CC-DG.

future.[8] The situation affecting the Care Center residents is especially egregious because CC-PA has resold their apartments and, instead of keeping the proceeds from the Entrance Fee paid by the new resident in order to repay the Care Center resident, CC-PA has upstreamed the money. Thus, Plaintiffs and the Class must hope CC-DG is still around and willing to pay when their refunds come due. *Id.*

Beginning in 2005, following receipt of borrowed Entrance Fees from the first residents entering the Community, and in each year thereafter, through 2013, CC-PA distributed to CC-DG, net of voluntary advances from CC-DG, millions of dollars in dividends of CC-PA's liquid assets from borrowed Entrance Fees, notwithstanding that, in each of such years, CC-PA had no earnings, a net loss from its operations, and a need for a large amount of cash required for statutorily mandated and prudent business reserves. FAC ¶ 103. As a result of these distributions, from 2005 through December 31, 2013, CC-DG received from CC-PA an aggregate of approximately $219,243,000 of CC-PA's liquid funds. CC-DG abjures any present or future obligation to return any portion of these distributions, regardless of CC-PA's financial condition or needs. *Id.*

Such distributions by CC-PA to CC-DG were made, and have continued in each year pursuant to CC-DG's business plan. FAC ¶ 104. CC-DG and CC-PA conspired to conceal this business plan from prospective residents. *Id.*

1. CC-PA's Own Actuarial Analysis Shows Insolvency

As stated in the 2012 actuarial study commissioned by Defendant Classic Residence Management Limited Partnership (Exhibit 4 to the FAC):

> The actuarial balance sheet for current residents indicated a deficit of approximately $152.8 million, or 32% of assets, demonstrating that Palo Alto's balance sheet does not reflect sufficient resources for current residents (including the actuarial present value of periodic fees expected to be paid in the future by present residents) to cover the actuarial present value of the expected costs of performing obligations to such residents under their contracts.

[8] *See, infra*, § III.B.2.; *see also* FAC ¶ 22 and Ex. 6 (Letter from Stephanie Fields, dated March 15, 2012) at p. 1.

FAC, Ex. 4, page 4. The findings of the actuarial study demonstrate the insolvency of CC-PA under both a "balance sheet" test and a "cash flow" test. The study finds that CC-PA has liabilities far in excess of assets and that CC-PA's expected income stream will not cover liabilities.

The DSS' August 2, 2012 letter to Stephanie Fields, Tara Cope and Gary Smith of CC-DG states:

> [T]he Department of Social Services (Department) has concerns regarding CC-Palo Alto, Inc.'s (CC-PA) financial position as reported in both its Consolidated Financial Statements (audited) for the fiscal year ending (FYE) December 31, 2011, and the Actuarial Study for Vi Palo Alto as of the same date. Reduced to simplest terms, the GAAP financial statements show: (1) total liabilities that exceed total assets by $282 million; (2) net losses (after tax benefit offsets) of $9.7 million and $5.5 million for 2011 and 2010, respectively; (3) net negative cash flows of $1.29 million and $686,000 for 2011 and 2010, respectively; and(4) CC-PA's practice of making substantial upstream cash distributions to parent CC-Development Group, Inc. (CC-DG) for 2011 and 2010 that amounted to $6.57 million and $8.43 million, respectively.
>
> At the same time, the Vi at Palo Alto actuarial study produced an actuarial balance sheet showing a deficit of $152.8 million (32% of assets) indicating that CC-PA "does not possess sufficient resources for current residents (including the actuarial present value of periodic fees expected to be paid in the future by present residents) to cover the actuarial present value of the expected costs of performing all remaining obligations to such residents under their contracts." As a result, the study concluded that the Vi at Palo Alto community "is not in Satisfactory Actuarial Balance" under the Actuarial Standards of Practice. Not coincidently, CC-PA's cumulative distributions of cash to CC-DG (in excess of paid-in capital) of $180.3 million more than account for the $152.8 million deficit on CC-PA's actuarial balance sheet.
>
> . . .
>
> [T]he issue is whether CC-PA's distributions of cash to its *non-provider* parent have weakened CC-PA's financial position so that it is (or the Department may have reason to believe that it is) "insolvent, is in imminent danger of becoming insolvent, is in a financially unsound or unsafe condition, or that its condition is such that it may otherwise be unable to fully perform its obligations pursuant to continuing care contracts" …
>
> …
>
> CC-PA's financial statements show declining cash and cash equivalents (to approximately $1.56 million as of December 31, 2011) and an increasing entrance fee repayment obligation (reported as $431.7 million in the 2011 GAAP financials). Moreover, CC-PA's repayment obligation applies to an increasing number of Health Center residents. As those

> residents' units are likely to be resold before they leave the Health Center (and their contracts are terminated), the obligation to repay those entrance fees will not necessarily (and probably will not) coincide with any offsetting revenue from the resale of the payee residents' residential units. If the entrance fee from the resale of a Health Center resident's unit has already been collected and distributed to CC-DG when the Health Center resident's contract terminates, CC-PA's cash will not be sufficient to make the entrance fee repayment due.
>
> The issue of adequate available cash will also arise whenever the contingent-on-resale condition on CC-PA's repayment obligation expires. If a residential unit remains unsold for 10 years, the entrance fee repayment obligation will again mature without any offsetting revenue from the resale of the resident payee's residential unit.

FAC, Ex. 5.

The cases Director Defendants cite in support of their solvency arguments are both misconstrued by Director Defendants and distinguishable. In *Francotyp-Postalia*, 1998 Del. Ch. LEXIS 234, the Court analyzed the solvency of a closely held corporation formed by two corporations that planned to engage in a joint venture to manufacture and sell inkjet modules. *Id*. at *2. The agreement between the two founding corporations permitted below cost sales to be made to the startup (the nominal defendant) with corresponding credits. The Court found that the nominal defendant was not insolvent because its cash flow deficiency was caused by below-cost sales to the plaintiff, and the resultant loans from plaintiff were not due until there were sales to third parties and resulting profits. *14-15. At issue in this case are loans from senior citizens which CC-PA is contractually and unconditionally obligated to pay; they are not payable only in the event CC-PA has enough money. Here, true insolvency is patent. Notably, the Court in *Francotyp-Postalia* **made its solvency determination only after trial and expert testimony on the issue of solvency**. *Id.* at *14-16. *See, infra*, § III.B.3.

In *Banks v. Cristina Copper Mines, Inc.*, 99 A.2d 504 (1953), at issue was a creditor petition for the appointment of a receiver. *Id.* at 505. The Court in *Banks* found that the corporation had the capacity to pay its creditors:

> When certain creditors of defendant asserted their claims defendant was able to pay them, largely, it is true, by the issuance of its stock to the creditors. As to other obligations, these have been met by loans to the company from certain of its officers and directors. Defendant asserts that it is in a position to pay at once any amount which may be determined to be due under this claim [from the law firm]. The balance sheet of defendant

> shows assets of more than a million dollars over the amount of its total indebtedness.

Id. at 507. The facts of this situation are distinctly different. Not only does CC-PA not have a positive balance sheet, but there is no evidence before the Court that CC-DG continues to be willing and able to advance money to CC-PA to repay the Entrance Fee Notes.

2. CC-DG Has Disclaimed Responsibility for Repaying the Entrance Fee Loans

CC-DG has expressly disclaimed any responsibility for returning the funds that it caused CC-PA to dividend to it. Nor is there any evidence that CC-DG is in a financial position to advance funds to CC-PA. This makes the situation distinguishable from *In Re Teleglobe Communs. Corp.*, 392 B.R. at 601, where the Court found solvency based on a parent company's funding of its subsidiary. Pritzker Mot. 10:19-11:9. There are no "reasonable prospects" that the Entrance Fee Notes will be paid by CC-DG because it has expressly denied any obligation to do so. CC-DG's position is that CC-PA is the "sole entity responsible" for the refund of Plaintiffs' Entrance Fees, and that CC-DG has no such responsibility. *See* FAC ¶ 22, Ex. 6 (Letter from Stephanie Fields, dated March 15, 2012) at p. 1.

Director Defendants argue that "[t]here is no dispute that the financial business model for this community includes new residents replacing those that leave, with the new entrance fees available to pay whatever is left on the prior resident's note."[9] Pritzker Mot. 11:10-12. This statement is patently untrue, because CC-DG's "business model" is that the new entrance fees be annually upstreamed, leaving CC-PA bereft of the funds available for repayment of the loans of residents who leave the community. As stated in the FAC ¶¶ 80-96, CC-PA's loan repayment obligations are not contingent on resale of a resident's apartment, or upon CC-PA's receipt of sufficient resale proceeds to fund the loan repayments. Defendants obviously hope that future sales' proceeds will be sufficient to enable them to repay departed residents, but that is not what prospective residents were promised. Plaintiffs were promised financial security, and they

[9] It should be noted that Defendants have never introduced their claimed "business model." Whether it exists, what it says, and whether there is a shred of evidence that they disclosed this information to incoming residents are all issues to be resolved through discovery. The content of Defendants' business model is not a topic for determination at the pleading stage.

reasonably expected that cash reserves would be funded to secure CC-PA's repayment obligations. Finally, implicit in the above quote from the Pritzker Motion ("whatever is left on the prior resident's note"), is that Director Defendants' apparently believe that the notes securing the refundable portion of the Entrance Fees amortize over time and therefore are susceptible to being repaid by new entrance fees; however, they do not amortize.

3. CC-PA's Insolvency is Question of Fact that Cannot be Resolved at the Pleading Stage

Fundamentally, the financial status of CC-PA is not an issue that lends itself to determination on a motion to dismiss. It is fact intensive and will ultimately require expert testimony. For the pleading stage, the FAC contains ample evidence of CC-PA's insolvency. As the Defendant in *Quadrant* contended (102 A.3d at 177), Director Defendants argue CC-PA is "solvent," and inject material outside the pleadings into their motion to dismiss. *See, e.g.,* DiGennaro Declaration and related argument in Pritzker Mot. The Pritzker Motion's claim that "CC-PA also has other sources of funding [in addition to funds from CC-DG], including entrance fee loans and bank loans" (Pritzker Motion 11:6-7) must be disregarded. As the *Quadrant* court did, this Court should reject Director Defendants' attempts to use extrinsic material; doing so is contrary to general principals of pleading practice. *See* Plaintiffs' Opposition To Defendants' Request For Judicial Notice And Objections To Evidence. A review of the Pritzker Motion shows that much of the Motion is devoted to references to extrinsic material. That Director Defendants feel the need to go beyond the four corners of the pleading to argue over the status of CC-PA finances evidences that their motion is grounded in factual disputes that are not appropriate for determination at the pleading stage (or possibly on a motion for summary judgment). *See* Pritzker Motion 8:6-9:6; 11:14-23; 14, fn.4. This Court already rejected similar efforts by Corporate Defendants in the initial Motion to Dismiss. *See* Order, November 25, 2014 at 8:17-25 (Doc 55).

C. Controlling Ninth Circuit Law Permits Plaintiffs to Pursue Both Class and Derivative Claims

Director Defendants mistakenly claim that Plaintiffs and their counsel cannot pursue the

derivative claims because the simultaneous prosecution of class action and derivative claims raises a conflict of interest. Pritzker Motion at 15. Controlling Ninth Circuit authority holds otherwise. Director Defendants claim that while the "Ninth Circuit has not expressly addressed the issue [regarding dual representation], it has suggested that dual representation violated Rule 23.1." Pritzker Mot. 16:6-7. To the contrary, the Ninth Circuit explicitly held in *Yamamoto v. Omiya*, 564 F.2d 1319, 1326 (9th Cir.1977) that a dual class action and derivative claim is permissible. In that case the Ninth Circuit found that "a shareholder who alleges [damages flowing from] a deceptive or misleading proxy solicitation is entitled to bring both direct and derivative suits." *Id*. at 1325.

Further, in 1993 (then) Magistrate Judge Infante of the Northern District issued an opinion in *In re RasterOps Corp. Sec. Litig.*, 1993 U.S. Dist. LEXIS 21504, at *23 (N.D. Cal. Sept. 9, 1993) finding that the pleading stage was not the appropriate time to resolve what was a "theoretical conflict of interest" that could exist due to the combined prosecution of both a derivative and class claim. As here, the director defendants in the *RasterOps* case claimed that the plaintiffs (and their counsel) had an insurmountable conflict of interest in trying to obtain individual damages through a class action, while also pursuing damages from the corporation through a derivative claim. *Id.* at 22-24. Judge Infante described the issue and his reasoning as follows:

> The prevailing view appears to be that there is no per se rule prohibiting shareholders from simultaneously bringing both direct and derivative actions. Indeed, some courts have remarked that such simultaneous actions create a "surface duality," and present nothing more than a "theoretical conflict of interest." *Heilbrunn v. Hanover Equities Corp.*, 259 F.Supp. 936, 939 (S.D.N.Y. 1966); *Keyser v. Commonwealth Nat. Financial Corp.*, 120 F.R.D. 489 (M.D. Pa. 1988); *In re Dayco Corp. Derivative Secur. Litigation*, 102 F.R.D. 624, 630 (S.D. Ohio 1984).
>
> In the present case, Director Defendants have failed to establish that there is an actual conflict. Since plaintiffs' success in both actions is "equally contingent upon the proof of the same nucleus of facts, they and their counsel can be expected to attack all fronts with equal vigor." *Bertozzi v. King Louie Intern., Inc*., 420 F.Supp. 1166, 1180 (D.C. R.I. 1976). At most, Director Defendants perceive a potential conflict at the remedy stages of each litigation. However, Director Defendants' argument presupposes that liability is first resolved in plaintiffs' favor in both the class action and derivative suits, and that funds from the derivative action are diverted to the class action plaintiffs to the detriment of the present

> shareholders. The mere possibility of such a conflict arising is insufficient justification to deny plaintiffs Markleebeth and Ivers standing to sue at the pleading stage. Should an actual conflict arise, the Court may properly revisit the issue at that time.

Id. at 23-24. This same analysis applies to this litigation. Exactly the same "nucleus of facts" is at issue in both the putative class action and in the creditor derivative case. That an election of remedies may come at some point during the litigation, does not equal a fatal conflict of interest sufficient to deny plaintiffs standing at the pleading stage. In the present litigation plaintiffs' primary motive is to recover the financial security they were promised. Nothing in the record suggests that Plaintiffs are prosecuting this litigation to secure a windfall. *See also*, *Natomas Gardens Inv. Group, LLC v. Sinadinos*, No. CIV. S-08-2308 FCD/KJM, 2010 U.S. Dist. LEXIS 48594, at *17 (E.D. Cal. Apr. 22, 2010); *see also In re Corinthian Colls. S'holder Derivative Litig.*, No. SA CV 10-1597-GHK (PJWx), 2012 U.S. Dist LEXIS 188623, at *47 (C.D. Cal. Jan. 30, 2012) (A "'theoretical conflict of interest' based on one counsel representing parties in both an individual and a derivative action does not justify a per se rule prohibiting the concurrent representation.").

Director Defendants cite to Rule 23.1's requirement for maintaining a derivative action and the language that a derivative action "may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association." Pritzker Mot. 15:10-13. However, Rule 23.1 is addressed in a number of the above mentioned cases, and the Courts have permitted dual individual (or class) and derivative actions. *See*, *e.g., In re Corinthian Colls. S'holder Derivative Litig.*, 2012 U.S. Dist LEXIS 188623, at *45. Director Defendants choose to cite *Larson v. Dumke*, 900 F.2d 1363, 1367 (9th Cir. 1990) in support of their Rule 23.1 argument. However, in *Larson* the Ninth Circuit reversed a district court decision dismissing a derivative claim on the grounds that the plaintiff did not qualify as an adequate representative notwithstanding the Court's finding that "Larson was not similarly situated with the other shareholders." *Id*. at 1367. Notable for purposes of this litigation, the Ninth Circuit in *Larson* said that "[t]he degree of support a putative plaintiff receives from other shareholders [here creditors], however, is a factor that should be considered in determining adequacy of

representation." *Id.* As reflected in the FAC, four hundred sixty residents demanded mediation on the same facts that are at issue in this case. FAC ¶ 53. Further, dozens of residents attended the last hearing in this case. The named Plaintiffs will appropriately represent the interests of their fellow residents, and there is no hint in the record that their interests are not aligned with those of the rest of the residents or that they lack the support of their fellow residents. Quite the opposite is true.

Director Defendants cite *Bass v. First Pact* [sic, Pacific] *Networks, Inc.*, No. C 92-20763 JW, 1993 WL 484715, *1, and claim that like in *Bass*, the Plaintiffs in this litigation have an "outside entanglement" that is "fatal" to their representation of CC-PA in a derivative action because they are pursuing class claims. Although the short *Bass* decision does not contain much factual background regarding Mr. Bass' derivative case and his separate "personal suit," there is enough to easily determine that the situation in *Bass* is not analogous to that presented in the Vi at Palo Alto litigation. In *Bass* the Court found that "Bass seeks relief on behalf of shareholders in the derivative action that is clearly designed to impact his own suit." The Court notes that in the derivative case Mr. Bass sought to compel the corporation to amend a prospectus to state that the corporation was holding Mr. Bass' stock certificates despite Mr. Bass' demand they be returned. *Id.* Despite the clear differences between *Bass* and the present litigation, Director Defendants' discussion of *Bass* spans three pages of their Motion. Pritzker Mot. 15-17. Here, Plaintiffs' interests are fully aligned with the interests of the rest of the resident/creditors.

Director Defendants' Motion stretches the holding of various cases past the breaking point. A case in point is Director Defendants' citation to *Ruggiero v. American Bioculture, Inc.*, 56 F.R.D. 93, 95 (S.D.N.Y. 1972), which Director Defendants cite for the sweeping proposition that "[o]ther federal courts have recognized that an individual cannot serve as the representative plaintiff in both a direct class action and a derivative action because of the inherent conflict of interest." Pritzker Mot. 16, fn.5. The *Ruggiero* case hardly stands for an open and shut statement that a plaintiff cannot pursue both a class action and derivative action. Director Defendants purport to include a direct quote from the decision in their brief but leave out key words and phrases from the quote: "In this case, it is difficult to see how the Freed plaintiffs can reconcile

their existing duties to Bioculture and its present shareholders as derivative plaintiffs with the duties which they seek to assume on behalf of a class which attacks Bioculture and embraces persons who now hold no Bioculture shares." (underlining added to show omitted words). The omitted words demonstrate that the statement was based on the unique facts of the *Ruggiero* case. In *Ruggiero* the Court ultimately permitted combined derivative and class claims but decided that two competing sets of counsel would represent the plaintiffs in the different counts.

Director Defendants also cite *Boilermakers Local 154 Retirement Fund v. Chevron Corp*., 73 A.3d 934 (Del. Ch. 2013), as standing for the proposition that combined derivative and individual claims are not permitted in Delaware – setting aside the obvious issue, which is that we are not litigating in Delaware state court – a close reading of *Boilermakers* shows that the statement that Director Defendants quote is *dicta* and that it ties back to a misreading of *Ruggiero*. *See* Pritzker Mot. 16, fn. 6; *see also*, *Boilermakers*, 73 A. 3d at 961 and 961, fn. 136. Further, Director Defendants are wrong as to whether derivative and class claims can be litigated together in Delaware—they can.

In *Loral Space & Communs., Inc. v. Highland Crusader Offshore Partners*, L.P., 977 A.2d 867, 868 (Del. 2009), the Supreme Court of Delaware rejected a defendant company's appeal, which was based on the company's argument that the trial court erred in allowing the matter to proceed as both a class and a derivative action. The Court held that "[b]oth types of claims may be litigated at the same time." *Id.* Further, the *Loral* decision reflects that the same complaint asserted both derivative and class claims. *Id*.

Similarly, in *Allen v. El Paso Pipeline GP Co., L.L.C*., 90 A.3d 1097, 1105 (Del. Ch. 2014) the Court of Chancery of Delaware stated that "[s]ome theories can be asserted either as direct or derivative claims, in which case '[b]oth types of claims may be litigated.'" The Court's footnote 1 in the *Allen* case collects a long list of cases that stand for the principal that the same facts may support both direct and derivative claims. *Allen* involved a class certification motion, which the Court granted, while at the same time determining that it was premature to make decisions regarding remedies. *Id* at 1111. In *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618,

655 (Del. Ch. 2013), the Court of Chancery of Delaware summarized the dual claim analysis that should take place:

> To determine whether a claim is derivative or direct, this Court must consider "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004). Although each question is framed in terms of exclusive alternatives (either the corporation or the stockholders), some injuries affect both the corporation and the stockholders. n14 If this dual aspect is present, a plaintiff can choose to sue individually. *Loral Space & Commc'ns Inc. v. Highland Crusader Offshore P'rs*, L.P., 977 A.2d 867, 868 (Del. 2009) (holding that where facts give rise to both derivative and direct claims, "[b]oth types of claims may be litigated").

Id. at 655. Here, there are two types of harm that flow from the same factual events (the upstreaming to CC-DG)—first, there is direct harm to the residents who are alienated from their security—second, there is harm to the corporation (CC-PA) and to the corporation's creditors (a derivative claim).

Finally, in response to Director Defendants' argument that there is a conflict of interest due to Plaintiffs' prayer for attorneys' fees—attorneys' fees are regularly awarded in derivative cases. Under the "substantial benefit" doctrine, counsel who prosecute a shareholder's derivative case that results in benefits being conferred on a corporation are entitled to attorneys' fees and costs. *See Boeing Co. v. Van Gemert*, 444 U.S. 472, 478 (1980); *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240 (1975)(derivative cases present an exception to the American Rule regarding attorneys' fees, along with common fund cases). Payment of attorneys' fees is appropriate under the substantial benefit rule when the litigation directly or indirectly confers substantial benefits on an ascertainable group. *Mills v. Elec. Auto-Lite Co*., 396 U.S. 375, 393 (1970). Indeed, attorneys' fees are only as a result of settling the underlying dispute on favorable terms.

D. Plaintiffs Have Properly Asserted a Claim for CC-DG Aiding and Abetting Director Defendants' Breach of Their Fiduciary Duties Owed to CC-PA

CC-DG and its directors assisted, aided and abetted the directors of CC-PA breaching the fiduciary duty the CC-PA directors owed to CC-PA. CC-DG contends that it owes no duty to

CC-PA because CC-PA is a wholly owned subsidiary of CC-DG. This same argument was rejected in *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283 (Bankr. D. Del. 2006). In *In re Scott Acquisition Corp.* the Court analyzed prior Delaware decisions and found that the general proposition that the directors of a wholly owned subsidiary only owe fiduciary duties to the parent corporation is altered in the case of an insolvent corporation—upon insolvency the directors of the subsidiary owe fiduciary duties to the subsidiary corporation. *Id*. at 286-287.

The Corporate Defendants acknowledge that CC-DG can be liable for aiding and abetting a breach of fiduciary duty, arguing only that Plaintiffs have not alleged insolvency. Under Delaware law, creditors of an insolvent corporation have standing to assert a derivative claim for breach of fiduciary duty against the directors of the insolvent corporation. In this case, the identities of the directors of CC-PA who breached the fiduciary duties they owed to CC-PA are each directors or senior executive officers of CC-DG, it is indisputable that CC-DG and its directors were aware of and participated in the upstreaming of funds which resulted in CC-PA's insolvency and breached the duties the CC-PA directors owe to CC-PA. This is sufficient to allege aiding and abetting a breach of fiduciary duty by CC-DG and its directors against CC-PA. In addition, as a parent corporation, CC-DG owes fiduciary duties to its subsidiary, CC-PA, when, as here, there are parent-subsidiary dealings. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720. (Del. 1971). An intrinsic fairness standard is applied when, as here, the parent by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary (the upstreaming) to the detriment of shareholders or creditors. *Id*.

E. Director Defendants Have Ratified Unlawful Dividends Under Delaware Law; Plaintiffs Are Entitled to Declaratory Relief

Director Defendants address Plaintiffs' request for declaratory relief (Tenth Count) only in passing to state that Plaintiffs are not entitled to declaratory relief because the allegations mirror the allegations in the Thirteenth Count (Unlawful Dividends) and Plaintiffs cannot plead derivative standing. Pritzker Motion 18, fn. 9. As argued at length *supra*, Plaintiffs do have derivative standing. Further, to obtain declaratory relief, Plaintiffs need demonstrate only the

existence of an actual controversy; they need not show present damages. *See Allstate Ins. Co. v. Huerta*, NO. CIV. S-06-856 LKK/KJM, 2006 U.S. Dist. LEXIS 69486, at *5 (E.D. Cal. Sept. 13, 2006) ("The Declaratory Judgment Act provides a mechanism by which parties may define their rights, duties or obligations regarding a controversy not yet ripe for adjudication. Declarations may be sought in a broad range of issues, such as contract interpretation."); *see also Barnes v. Windsor Sec. LLC*, 2013 U.S. Dist. LEXIS 116570, *7 (N.D. Cal. Aug. 15, 2013) (denying motion to dismiss, and holding that "any person may bring an action for a declaration of that person's rights and duties under a contract, and such a declaration shall have the force of a final judgment.").

Plaintiffs are entitled to declaratory relief addressing, among other things, the refundable nature of the contracts under Health and Safety Code § 1771(r)(2), and the applicability of the reserve requirement of Health and Safety Code § 1792.6, as well as the parties' disparate reading of the terms of the Residency Contracts, including whether marketing costs are being properly allocated, whether the residents must bear the increase in property taxes due to upstreaming, whether residents must bear the entire cost of earthquake insurance, and whether they would be responsible for a multi-million dollar deductible if there were significant earthquake loss. *See e.g.,* FAC ¶¶ 24-30, 197-200. They are also entitled to declaratory relief addressing the violations of Delaware Corporation Law. FAC ¶¶ 197-200. Claims for declaratory relief are particularly appropriate when there is a dispute between parties regarding the interpretation of a contract, and parties' respective rights and obligations arising under that contract are at issue. *See, e.g., Clear Channel Outdoor, Inc. v. Bently Holdings Cal. LP*, No. C-11-2573 EMC, 2011 U.S. Dist. LEXIS 140764 at *17 (N.D. Cal. Dec. 7, 2011).

F. Plaintiffs Have Adequately Pled That Director Defendants Authorized Unlawful Dividends and Engaged in Corporate Waste

Plaintiffs have adequately alleged a claim for corporate waste against Director Defendants – which they are entitled to do by virtue of their status as creditors of an insolvent corporation. As alleged in the FAC, from 2005 through 2013, CC-PA has had no surplus within the meaning of Section 154 of the Delaware General Corporation Law, and as reflected in Sections 170 and

173. FAC ¶ 101. In each year from 2005 through 2013, CC-PA has had insufficient funds to repay its borrowing from residents in the Care Center as its obligations to such residents have matured upon death or departure of such residents. FAC ¶ 102. As the result, to enable CC-PA to pay its maturing obligations, CC-PA has had no choice but to ask CC-DG for funds—convincing evidence that CC-PA is insolvent. Director Defendants violated Sections 170 and 173 of the Delaware General Corporation Law by virtue of their wasting of CC-PA's assets through the payment of illegal dividends. By virtue of Section 174 of the Delaware General Corporation Law Director Defendants are liable to CC-PA and to CC-PA's creditors for the full amount of the dividend unlawfully paid, with interest.

G. Plaintiffs Have Adequately Pled That CC-DG is Responsible for the Fraudulent Transfer of Assets[10]

CC-DG claims that absent insolvency, "in a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders." Corporate Defendants' Motion 32:16-21. As explained *supra*, CC-PA is insolvent and this fact is adequately alleged in the FAC. The situation in this case presents a classic fraudulent transfer pursuant to Delaware Code, Title 6, § 1304(A)(1) & 1305(A) and California Civil Code §§ 3439.04 and 3439.05. The upstreaming is not grounded on any reasonable business objective – rather, it is grounded in a desire to cut off Plaintiffs' security interests. CC-DG retains effective control of CC-PA through ownership, and is thus an Insider. 6 Del. C. 1301(7).

Corporate Defendants argue that the upstreaming lacks any of 11 "badges of fraud" mentioned in Civil Code §3439.04(b)(1)-(11) – to the contrary, numerous of the "badges of fraud" are present: CC-PA did not disclose to Plaintiffs that it had upstreamed these funds; CC-PA upstreamed the funds to an Insider (i.e. CC-DG); the upstreaming drained CC-PA of substantially all of its liquid assets; CC-PA was insolvent at the time of the upstreaming, or

[10] Plaintiffs address their Fraudulent Transfer of Assets Count, the Fourteenth Count of the FAC in this brief due to the fact that it is grounded partly in Delaware law, and because it is a derivate claim. FAC ¶¶ 231-243.

became insolvent as a result of the upstreaming; and, the transfers occurred shortly after substantial debts (Entrance Fee Notes) were incurred (the transfers were made on a regular basis as more Entrance Fees were paid in order to keep funds out of the entity that owed the refunds). CC-PA cannot possibly show that it received anything of value in return for upstreaming funds to CC-DG.

H. Plaintiffs Have Adequately Pled Direct Claims, in Addition to Derivative Claims, Against Director Defendants

The majority of the Pritzker Motion is devoted to argument regarding Plaintiffs' derivative claims against Director Defendants, although there is brief argument included concerning the direct claims alleged against Director Defendants.

On the direct claims, Director Defendants' rely on a basic premise expressed in *Silicon Knights v. Crystal Dynamics*, 983 F. Supp. 1303 (N.D. Cal. 1997) that:

> under California law, "directors or officers of a corporation do not incur personal liability for the torts of the corporation merely by reason of their official position, unless they participate in the wrong or authorize or direct that it be done. They may be liable, under the rules for tort and agency, for tortious acts committed on behalf of the corporation.

Id. at 1308. Defendants then string cite to six cases where various Courts found there was not enough detail in the complaint at issue. The string cited cases provide nothing of value other than to point out that sometimes complaints do not contain enough factual allegations. Interestingly in the *Silicon Knights* case the Court did find that enough had been alleged against the individual defendants when the complaint:

> set[] forth their respective positions within the corporation and allege[d] that 'Crystal Dynamics acted by and through the other individual Defendants named herein' in 'committing the fraudulent and otherwise wrongful actions alleged herein …' Complaint P.2. This allegation, coupled with specific acts of fraud and misconduct alleged throughout the complaint is sufficient to inform individual defendants of their 'relationship to the actions at issue in the case' and the basics of their alleged liability for the tort claims alleged in the complaint.

Id. at1303. Here, the FAC puts Director Defendants on notice of their relationship to the actions at issue in the case.

1. Plaintiffs Have Alleged Personal Participation by Director Defendants

Each of Director Defendants' backgrounds with CC-PA is described in the FAC. *See* FAC ¶¶ 38-45. Further, details of their involvement in the financial management of CC-PA, their actions to benefit CC-DG at the expense of CC-PA, and their actions to reject Plaintiffs' attempts to remedy the financial improprieties are all catalogued in the FAC. *See* FAC ¶¶ 106-11, 156-184. Each was a Director of CC-PA during relevant periods to the events in the case, including creating the "business plan" involving upstreaming of CC-PA's cash from Entrance Fees. The gravamen of the FAC on this issue is the upstreaming of funds. Director Defendants each instructed, carried out and later attempted to ratify CC-PA's yearly upstreaming of funds to CC-DG. While doing so, as officers; and in some cases, as directors; and in some cases, as owners (directly or indirectly) of CC-DG, they owed their primary allegiance to CC-DG, from which they received their primary compensation. *Id.,* and ¶¶ 173-184.[11] Again, the upstreaming occurred only upon Director Defendants' instruction and with their participation as officers of CC-PA and CC-DG, in order to benefit CC-DG.

2. Director Defendants Assisted in Financial Elder Abuse and are Thus Liable under the Plain Language of the EADACPA

Plaintiffs have alleged that the each of the Defendants is responsible for financial elder abuse under California's Elder Abuse and Dependent Adult Civil Protection Act ("EADACPA") which prohibits Defendants from obtaining or retaining property of an elder when they "knew or should have known that [their] conduct is likely to be harmful to the elder…" (Welfare & Inst. Code § 15610.30) (emphasis added.). FAC ¶ 9.

The EADACPA defines "financial abuse" as follows:

§ 15610.30. "Financial abuse" of elder or dependent adult

[11] Delaware law recognizes that directors' exercise of their statutory power to manage a corporation "carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." *Aronson v.* Lewis, 473 A.2d 805, 811 (Del. 1984) (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)). Under Delaware law, when a wholly-owned subsidiary is insolvent, the subsidiary's directors owe fiduciary duties to the subsidiary (CC-PA). *See In re Scott Acquisition Corp.*, 344 B.R. at 286; *In re Direct Response Media*, 466 B.R. 626, 649 (Bankr. D. Del. 2012) ("the [subsidiary's] directors . . . cannot allow the subsidiary to be plundered for the parent company's benefit."); *see also Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787-90 (Del. Ch. 1992)*; *Official Comm. of Unsecured Creditors of High Strength Steel, Inc. ex rel. Estate of High Strength Steel, Inc., 269 B.R. 560, 569 (Bankr. Del. 2001)*.

> (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:
>
> (1) Takes, secretes, appropriates, obtains, or retains real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both.
>
> (2) Assists in taking, secreting, appropriating, obtaining, or retaining real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both.
>
> (b) A person or entity shall be deemed to have taken, secreted, appropriated, obtained, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates, obtains, or retains the property and the person or entity knew or should have known that this conduct is likely to be harmful to the elder or dependent adult.
>
> …
>
> (c) For purposes of this section, a person or entity takes, secretes, appropriates, obtains, or retains real or personal property when an elder or dependent adult is deprived of any property right, including by means of an agreement, donative transfer, or testamentary bequest, regardless of whether the property is held directly or by a representative of an elder or dependent adult.

In this case, Defendants took, secreted, appropriated, obtained and retained money belonging to Plaintiffs and the Class they seek to represent for a wrongful use and with the intent to defraud and when they knew or should have known that this conduct was likely to be harmful to Plaintiffs and the Class. FAC ¶ 194. Defendants have wrongfully deprived Plaintiffs and the Class of their personal property by improperly collecting hundreds of millions of dollars in "Entrance Fees" through CC-PA and transferring those funds upstream to CC-PA's corporate parent, CC-DG, thus impairing Plaintiffs' and the Class' security interest in those fees.[12] Because of Defendants' actions funds that were supposed to have remained at the provider level as security for repayment of Plaintiffs' Promissory Notes when they come due, and to create other prudent cash reserves to protect CC-PA against adverse contingencies—have instead been transferred upstream with no assurance that they will ever be returned. All of this is in violation of California law, which requires that cash reserves be maintained when a CCRC enters into a refundable contract with its residents. *Id.* Director Defendants controlled CC-PA through their positions on

[12] *See* Opposition to Corporate Defendants' Motion §§ IV.B.2. (statutorily created security interest) and IV.B.4. (contractually created security interest).

the Board of Directors during the times relevant to the FAC and they expressly ratified the upstreaming of funds to CC-DG. Under Section 170 of the Delaware General Corporation Law, only the Board of Directors of CC-PA is granted the authority, after having satisfied its statutory responsibilities, to declare and authorize CC-PA to pay legal dividends to CC-DG, CC-PA's sole shareholder. Of course here there was no consideration of the economic stability of the company prior to the passing of annual boilerplate resolutions, nor authorization before the fact of the illegal dividends.

Defendants have also overcharged Plaintiffs and the Class by improperly allocating increased tax assessments, earthquake insurance charges, and marketing costs to the Vi at Palo Alto's operating expense budgets, and passing on these charges as inflated monthly fees. FAC ¶ 194. These overcharges constitute a present harm to every Plaintiff and to the Class.

Defendants assisted one another in taking, secreting, appropriating, obtaining and retaining money and property belonging to Plaintiffs and the Class for a wrongful use and with the intent to defraud and when they knew or should have known that this conduct was likely to be harmful to Plaintiffs and the Class. FAC ¶ 195. More specifically, Plaintiffs have alleged that CC-DG's secret "business plan" was and is to induce Plaintiffs and the Class to lend substantial Entrance Fees, apparently, to CC-PA (but actually for the exclusive benefit of CC-DG), which CC-PA would then move upstream to CC-DG, according to plan. This plan kept CC-PA dangerously underfunded, in a state of financial distress and dependent on voluntary infusions of funds from CC-DG. In addition, all of the Defendants assisted one another in taking, secreting, appropriating, obtaining and retaining money and property belonging to Plaintiffs and the Class for a wrongful use and with the intent to defraud and when they knew or should have known that this conduct was likely to be harmful to Plaintiffs and the Class when they acted together to charge Plaintiffs and the Class inflated monthly fees. *Id.*

3. Plaintiffs Have Pled Their Claims Against Director Defendants with Sufficient Particularity

Director Defendants make the same argument as the Corporate Defendants that a heightened fraud based pleading standard should apply. The only claim to which this heightened

standard could apply in this case is to Plaintiffs' second cause of action for concealment. However, in cases that involve "corporate fraud," Rule 9(b)'s particularity requirement is "relaxed" because "the facts supporting the fraud are exclusively within the defendants' possession." *Estate of Migliaccio v. Midland Nat'l Life Ins. Co.*, 436 F. Supp. 2d 1095, 1106 (N.D. Cal. 2006). Plaintiffs more fully brief the reasons why a fraud based standard does not apply in their Opposition to the Corporate Defendants' Motion to Dismiss. *See* Opposition to Corporate Defendants' Motion to Dismiss §§ IV.A.2, and IV.E..

Here there is sufficient particularity as to the complained of actions by Director Defendants. Director Defendants controlled CC-PA by virtue of their roles as officers and directors. Among other things, the Residency Contract should have disclosed the plan to strip CC-PA of cash reserves and did not. The date of omission of this lack of disclosure with respect to each member of the Class is the date each entered into their respective Residency Contracts, as set forth in the FAC. The FAC also specifies that in lieu of any meetings of the Board, once each year, Directors of CC-PA have taken action by unanimous written consent pertaining to the matters affecting CC-PA and have passed boilerplate resolutions attempting to ratify all actions of the corporation, which include within the broad language of the resolution, all upstreaming of funds to CC-DG. This is enough for each Director Defendant to determine which of their actions is at issue.

As to Director Defendants' footnote 10 (chronicling instances in which there is not precise overlap between the dates that specific Defendants were directors and specific dates individual Plaintiffs resided at the Vi at Palo Alto) – the argument is specious. For instance the footnote argues that:

> The tax increase that CC-PA allegedly wrongfully allocated to residents' monthly fees did not occur until 2012, at a time when Defendants Penny and Nicolas Pritzker were no longer serving as officers or directors of CC-PA.

Pritzker Mot. 21, fn. 10. This deliberately misses the point that the tax increase was the result of a finding by the AAB that CC-PA's upstream transfer of over $174 million to CC-DG constituted "Entrepreneurial Profit," which the AAB included as taxable in its property tax appraisal. FAC ¶

117. During their tenure on the Board of CC-PA, Penny and Nicolas Pritzker – like the other Director Defendants – scripted and then attempted to ratify upstreaming that was included in the AAB's finding of "Entrepreneurial Profit." As to the other arguments in footnote 10, the fact remains that each of the Plaintiffs is a current resident of the Vi at Palo Alto and is suffering harm caused by Director Defendants, regardless of whether a specific Director Defendant remains on the Board of CC-PA, and regardless of whether a specific Director Defendant's tenure on the Board overlapped with the date a specific Plaintiff became a resident.

4. Director Defendants Owe a Fiduciary Duty to Plaintiffs

Director Defendants breached the fiduciary duty owed to CC-PA, which Plaintiffs have standing to assert as creditors of an insolvent corporation. The issue of insolvency is briefed in detail *supra*. Moreover, Director Defendants, along with the other Defendants, also breached a fiduciary duty owed directly to Plaintiffs arising in situations in which "confidence is reposed by persons in the integrity of others, and [whether] the latter voluntarily accept or assume to accept the confidence." *Tri-Growth Centre City, Ltd. et al. v. Silldorf et al.*, 216 Cal. App. 3d 1139, 1150 (4th Dist. 1989).

Here, Plaintiffs are all senior citizens who reposed trust in the Defendants. The reasons why there should be a finding that the facts of this case support a finding of fiduciary duty are fully briefed in Plaintiffs' Opposition to the Corporate Defendants' Motion to Dismiss. *See* Opposition to Corporate Defendants' Motion to Dismiss § IV.G.

Director Defendants rely on *Gheewalla*, a creditor derivative case, to argue that there can be no direct fiduciary duty; however, that case did not address the factual argument being made here, that by virtue of the specific facts of this case, which involve senior citizens who are parting with significant portions of their assets to live at a CCRC for the rest of their lives and who are, from the get-go, dependent on Director Defendants to provide and maintain their homes and residential environments and to fairly determine and allocate the costs to them, the facts lead to a fiduciary duty. Courts analyzing similar facts have found fiduciary relationships to exist between contracting parties where the defendant targeted senior citizens, which are a "protected class" in California. *See In re National Western Life Insurance Deferred Annuities Litigation*, 467 F. Supp.

2d 1071, 1087 (S.D. Cal. 2006); *Abbit et al. v. ING USA Annuity and Life Insurance Co.*, 2014 U.S. Dist. LEXIS 24715 *23-24, No. 13cv2310-GPC-WVG (S.D. Cal. Feb. 25, 2014) (denying motion to dismiss where plaintiffs alleged that "Defendant targets senior citizens with products that falsely promise security," and that "Defendant drafted all contractual material… taking advantage of [its] superior knowledge and bargaining power"); *Estate of John G. Migliaccio et al. v. Midland National Life Insurance Co. et al.*, 436 F. Supp. 2d 1095, 1108 (C.D. Cal. 2006) (denying motion to dismiss where plaintiffs alleged that defendants "trained their sales agents to lure senior citizens into their confidence by offering assistance with estate and financial planning, ultimately to sell them improper annuities").

Again, this is more fully briefed in the Opposition to the Corporate Defendants' Motion to Dismiss; but, it is critical to remember that this case alleges two varieties of fiduciary duty: the first is the fiduciary duty that Director Defendants owe CC-PA (which as creditors of an insolvent corporation, Plaintiffs have standing to assert), and the second is the fiduciary duty that Defendants owe the CCRC residents directly, which is derived out of the facts of the situation (Plaintiffs' age, the nature of the transaction, the relative bargaining power of the parties, etc.) and California case law.

IV. CONCLUSION

For the reasons stated herein, Director Defendants' Motion to Dismiss the FAC should be denied. However, to the extent this Court is inclined to grant the Pritzker Motion, it should do so without prejudice and give Plaintiffs an opportunity to cure any deficiencies.

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COTCHETT, PITRE & McCARTHY, LLP

By: */s/ Anne Marie Murphy*
NIALL P. McCARTHY
ANNE MARIE MURPHY
ERIC J. BUESCHER
DEMETRIUS X. LAMBRINOS

Attorneys for Plaintiffs Burton Richter, Linda Collins Cork, Georgia L. May, Thomas Merigan, Alfred Spivack, and Janice R. Anderson