ARNOLD & PORTER LLP
GILBERT R. SEROTA (No. 075305)
gilbert.serota@aporter.com
PETER OBSTLER (No. 171623)
peter.obstler@aporter.com
DIANA D. DIGENNARO (No. 248471)
diana.digennaro@aporter.com
Three Embarcadero Center, 10th Floor
San Francisco, CA 94111-4024
Telephone: +1 415.471.3100
Facsimile: +1 415.471.3400

Attorneys for Defendants
PENNY PRITZKER, NICHOLAS PRITZKER, JOHN POORMAN, GARY SMITH, STEPHANIE FIELDS and BILL SCIORTINO

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

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 other similarly situated, and derivatively on behalf of CC-PALO ALTO, INC.,

Plaintiffs,

vs.

CC-PALO ALTO, INC., a Delaware corporation; CLASSIC RESIDENCE MANAGEMENT LIMITED PARTNERSHIP, an Illinois limited partnership; and CC-DEVELOPMENT GROUP, INC., a Delaware corporation, PENNY PRITZKER, an individual, NICHOLAS J. PRITZKER, an individual, JOHN KEVIN POORMAN, an individual, GARY SMITH, an individual, STEPHANIE FIELDS, an individual, and BILL SCIORTINO, an individual,

Defendants.

vs.

CC-PALO ALTO, INC., a Delaware corporation,

Nominal Defendant,

Case No. C 14-00750 EJD

REPLY IN SUPPORT OF MOTION TO DISMISS FIRST AMENDED COMPLAINT BY DEFENDANTS PENNY PRITZKER, NICHOLAS PRITZKER, JOHN POORMAN, GARY SMITH, STEPHANIE FIELDS AND BILL SCIORTINO

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

Trial Date: None Set

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

OTHER AUTHORITIES

Defendants Penny Pritzker, Nicholas Pritzker, John Kevin Poorman, Gary Smith, Stephanie Fields, and Bill Sciortino (the "Directors"), respectfully submit this reply brief in support of their motion to dismiss all of Plaintiffs' claims for relief in the First Amended Complaint under Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure (the "Reply").

INTRODUCTION

Because Plaintiffs' claims are hypothetical and speculative, this Court properly dismissed their first complaint for failure to state a viable, present claim for relief. The Opposition to the Director Defendants' Motion to Dismiss ("Opp") does not show that the First Amended Complaint ("FAC") should fare any better. It attempts to establish derivative standing against the CC-PA officers and directors by assertion of a demonstrably phony "insolvency" theory which (1) improperly relies entirely on the collective amount of entrance fee re-payment obligations to establish a balance sheet deficit without any reasonable recognition that the payments are not due for years, and (2) asks the Court to adopt a theory of insolvency based on an actuarial report whose author has made it clear that CC-PA is solvent and that the analysis is not and should not be used as evidence of otherwise.

In this Reply Memorandum, the Director Defendants unravel the Opposition arguments and show that application of the correct law to the facts pleaded by Plaintiffs—and those unable to be pleaded—compel dismissal of these claims.

First, to avoid duplication, these defendants incorporate the Corporate Defendants' argument that Plaintiffs do not identify sufficient injury-in-fact to plead subject matter jurisdiction.

Second, Rule 23.1 bars Plaintiffs from asserting conflicting claims for monetary relief in the prosecution of both derivative and class claims. The cases relied upon by Plaintiffs do not countenance simultaneous prosecution of conflicting claims. Instead, they serve only to illustrate that prosecution of class and derivative claims can be allowed *if no such conflicts exist*.

Third, Plaintiffs' have failed to plead facts establishing that CC-PA is insolvent and, therefore, they lack creditor standing to pursue derivative claim against the Directors. Plaintiffs claim that insolvency can be established because the collective amount of entrance fee loans due at uncertain times *in the future* are greater than company's *current assets* is insufficient without facts

showing that the company has no reasonable prospect of successfully continuing as a business. Here, the pleaded facts are to the contrary. The financial statements and projections contained in exhibits to the FAC show positive past and future cash flow sufficient to meet CC-PA's obligations. Even the third party actuary referenced in the FAC has confirmed that CC-PA's solvency is "beyond question." Declaration of Diana DiGennaro In Support of Motion to Dismiss ("DiGennaro Decl.") Ex. A, Att. B at 2; *id.* Ex. A at 2.

Finally, Plaintiffs fail to plead facts sufficient to state direct claims for relief against the Directors. Plaintiffs allege only that these defendants held certain positions during the class period and did not fulfill their duties or act in the best interest of CC-PA. The alleged harm to CC-PA is, at best, derivative in nature, and fails to state any direct claim for relief against the Directors Defendants. And, Plaintiffs allege no facts that show that the Directors owe fiduciary duties to them as shareholders and creditors.

I. THE OPPOSITION FAILS TO SHOW FACTS SUFFICIENT TO SUSTAIN SUBJECT MATTER JURISDICTION.

The Director Defendants join in and incorporate by reference the Corporate Defendants' arguments regarding subject matter jurisdiction and any documents filed in support thereof. Plaintiffs still have not identified any facts demonstrating an injury in fact and their claims remain purely speculative. For these reasons, and those set forth in the Corporate Defendants' briefs, the Court lacks subject matter jurisdiction and the case should be dismissed.

II. PLAINTIFFS CANNOT PURSUE A DERIVATIVE ACTION UNDER RULE 23.1 BECAUSE THE PLEADINGS SHOW AN ACTUAL CONFLICT BETWEEN PLAINTIFFS' DIRECT AND DERIVATIVE CLAIMS.

The Opposition concedes that, under Rule 23.1, a derivative plaintiff must be able to represent the interests of the corporation free of conflicts of interest. But it never discusses the monetary claims for relief in the FAC that present irreconcilable conflicts between Plaintiffs' proposed roles as both class representatives and derivative plaintiffs. Instead, the Opposition devotes most of its argument to (1) the unremarkable proposition that there is no "per se" rule precluding a plaintiff from simultaneously representing a class and seeking a derivative recovery; (2) misplaced reliance on cases where an actual conflict was avoided by the type of relief requested;

and (3) citation to cases where Rule 23.1 was not at issue. The Opposition does not discuss or even mention at least two relevant cases cited by the Director Defendants which preclude Plaintiffs from pursuing derivative relief under circumstances analogous to those presented here.

There is no dispute by Plaintiffs that the FAC contains monetary claims for relief both *against* and *on behalf of* CC-PA. The Court need look no further than Section IX of the FAC entitled "Prayer for Relief" to see the obvious conflict of interest between the class and derivative claims. Under the title "Class Relief," Plaintiffs seek massive compensatory, punitive, and treble damages against CC-PA on behalf of the class. FAC at 68-69. These class claims *against CC-PA* seek penalties of $5000 per class member under the Consumer Legal Remedies Act, treble damages under separate sections of the Civil Code and Health and Safety Code, restitution, disgorgement, and punitive damages. *Id*. The "Derivative Relief" section seeks recovery *for the benefit of* CC-PA of damages for alleged illegal dividends and corporate waste. *Id*. at 69-70. The Opposition never discusses the nature and amount of these damages claims or the harm to CC-PA that would be caused by the large monetary relief sought by the class claims. It never explains how extracting huge damages *from CC-PA* is consistent with acting *on behalf* of it, where CC-PA's litigation objectives should be to maximize a recovery. The Opposition ignores these conflicting claims for damages and, instead, merely argues that the class and derivative prayers for "attorneys' fees" are not incompatible. Opp. at 20.

Failing to address the actual conflict arising from the claims for relief is not the only flaw in the Opposition argument. The principal cases relied upon by Plaintiffs to support simultaneous prosecution of claims for and against CC-PA are all inapposite. They either decide different legal issues or are easily distinguishable on their facts.

Plaintiffs' reliance on *Yamamoto v. Omiya*, 564 F.2d 1319 (9th Cir. 1977), is misplaced. In that case, plaintiff alleged a deceptive and misleading proxy solicitation and sought primarily equitable relief—not conflicting claims for damages—including a re-solicitation of proxies and avoidance of a real estate sales agreement entered into by the corporation. Not only is the case off point, but the Opposition misleadingly adds the words "[damages flowing from]" to its quote from the case (Opp. at 16:5-9), when there is no discussion by the court of the type or amount of damages

sought in the case. The *Yamamoto* decision allows the plaintiff to proceed both derivatively and directly because the relief available for a misleading proxy solicitation is essentially identical whether brought derivatively or directly.

Nor are the facts of *In re RasterOps Corp. Sec. Litig.*, No. 92–20115 RMW EAI, 1993 WL 476651 (N.D. Cal. Sep. 10, 1993), helpful to Plaintiffs. There, the relief sought in both the derivative and class claim was identical—recovery of alleged insider trading profits from *company insiders, not the company itself.* There was no issue of material harm to the corporation from damages sought from the corporation in the class action because no such damages were requested.

Plaintiffs' reliance on *Natomas Gardens Inv. Grp., LLC v. Sinadinos*, No. CIV. S082308 FCD KJM , 2010 WL 1659195 (E.D. Cal Apr. 22, 2010), is similarly misplaced. That court expressly determined that the derivative action did not conflict with the plaintiff's direct action because the direct action "does not seek damages" from the corporation. *Id.* at *5; *see also Keyser v. Commonwealth Nat'l Fin. Corp.*, 120 F.R.D. 489, 492-3 (M.D. Pa 1988) (finding no likely conflict in the remedies requested by the derivative and class actions).

Allen v. El Paso Pipeline GP Company, 90 A.3d 1097 (Del. Ch. 2014), relied upon by Plaintiffs, also has little or no relevance. In that case, Rule 23.1 was not at issue because the plaintiffs were *not* proposing to be dual class and derivative plaintiffs. Instead, the defendants were opposing class certification on the grounds that the nature of two of the causes of action alleged by plaintiffs were derivative, not direct. The court rejected this contention. *Id.* at 1111.[1]

In re Corinthian Colleges, Inc. Shareholder Derivative Litigation, No. SA CV 10-1597-GHK, 2012 WL 8502955 (C.D. Cal Jan. 30, 2012), is also irrelevant because the issue in that case was whether the *same counsel* could represent different plaintiffs in separate class and derivative actions. The court rejected this as a ground for disqualification under Rule 23.1 and stated that these concerns "are more properly entertained on a fully-briefed motion to disqualify counsel." *Id.* at *15.

[1] *Loral Space & Communications, Inc. v. Highland Crusader Offshore Partners, L.P.*, 977 A. 2d 867 (Del. 2009), is also misstated by Plaintiffs. That case has nothing to do with Rule 23.1, but rather with the issue of classification of claims as either direct or derivative and whether one type of action challenging a corporate reorganization might preclude the other.

While Plaintiffs spend several pages on cases that are irrelevant or easily distinguishable, they *completely ignore* cases cited in the Director Defendants' motion that are on point. *See* MTD at 15. Both *Bryant v. Mattel, Inc.*, No. CV 04-9094 DOC RNBX, 2010 WL 3705668 (C.D. Cal. Aug. 2, 2010), and *Guenther v. Pacific Telecom*, 123 F.R.D. 341 (D. Or. 1987), disqualify Plaintiffs under Rule 23.1 from serving as derivative plaintiffs where their monetary claims against the corporation conflict with their proposed role as derivative plaintiffs acting for the corporation against officers and directors. These cases recognize a disabling conflict under Rule 23.1 that is clearly present here—the potential that a derivative action for damages pursued by the *same* plaintiffs and *same* counsel that are pursuing a class action could be used as leverage to extract a more favorable settlement in the class action or vice versa. That prospect not only exists here, but may very well explain why the Director Defendants were not added until the initial complaint and attempts at mediation with the corporation (disclosed by Plaintiffs in the FAC and Opposition) each failed to produce a favorable result for Plaintiffs.

Because the claims for relief between the direct and derivative causes of action are incompatible and this case presents the prospect that claims against the Director Defendants might be used as leverage to obtain a more beneficial settlement of the class claims, Rule 23.1 precludes the same plaintiffs from suing derivatively. Accordingly, the derivative counts in the FAC—Causes of Action 11 through 15—must each be dismissed.

III. THE OPPOSITION'S INSOLVENCY ANALYSIS IS WRONG ON THE LAW AND INCONSISTENT WITH THE ALLEGATIONS IN THE FAC.

According to their Opposition, Plaintiffs' derivative claims are all based on the theory that CC-PA is insolvent because the total sum of all the entrance fees scheduled for repayment *at various dates in the future* exceeds the alleged value of CC-PA's assets *today*. *See* Opp. 1:12-16; 8:21-15:25. Allegations that the collective amount or sum of contingent, future liabilities exceed the amount of present day assets on a company balance sheet is not sufficient to establish insolvency under Delaware law. At best, these allegations establish that a purely paper deficit exits between contingent liabilities and current assets. They do not establish or explain, however, how the alleged "deficit" has interfered or will interfere with the company's ability to meet its financial

obligations, including any future obligations it has to return portions of entrance fees as they eventually come due at various dates in the future.

First, Delaware and federal courts uniformly hold that an alleged balance sheet deficit must be accompanied by allegations establishing that the allegedly insolvent company has "no reasonable prospect" of financial survival. A simple "balance sheet" deficit pleading standard "ignores the realities of the business world in which corporations incur significant debt in order to seize business opportunities," and allows disgruntled plaintiffs, like these, to improperly leverage changes to an otherwise viable business model through strike suits that threaten a company with "premature appointment of custodians and potential corporate liquidations." *See Francotyp-Postalia AG & Co. v. On Target Tech., Inc.*, No. 16330, 1998 WL 928382, at *5 (Del. Ch. Dec. 24, 1998). *See* Section III(B), *infra*.

Second, Plaintiffs allegations are insufficient to establish insolvency even under the simplistic balance sheet test they propose. According to Plaintiffs, their insolvency allegations are based on a on a paper balance sheet deficit that the Company's actuary allegedly identified in a "study." Opp. at 1:12-13; 2:3-8; 11:19-12:4; FAC Ex. 4. Plaintiffs' characterization of the study is refuted by the author himself, who clarified its findings to make clear that it neither found nor implied that CC-PA was insolvent or in "imminent danger of becoming insolvent." Plaintiffs' balance sheet insolvency theory is also refuted by their own allegations showing that the date upon which the alleged liabilities are due is contingent as to both circumstances and timing. As a result, plaintiffs fail to plead what the present value of the debts are or why the timing of debts contingent on future events renders CC-PA insolvent today. *See* Section III(C) and (D), *infra*.

Third, Plaintiffs argue that CC-PA is insolvent under a cash flow test because its repayment obligations are allegedly contingent on its ability to obtain outside funding from CC-DG. Not so. "Cash flow" insolvency cannot be based solely on paper deficit allegations alone. There must be a factual showing that the deficit has affected or will affect the ability of the company to make is payments as they become due. Not only is there no allegation that CC-Pa has ever missed a single payment when due, the documents relied upon by Plaintiffs in the FAC establish the opposite — CC-PA's cash flow is sufficient to meet its obligations. *See* Section III(E), *infra*.

A. The Court Should Dismiss Defective Insolvency Allegations at the Pleading Stage.

Plaintiffs seek to avoid dismissal of the derivative claims by arguing that whatever the merits or theory of insolvency, the issue can never be decided on the pleadings and they should be able to commence discovery on this and other subjects. Plaintiffs are wrong. "Delaware law clearly requires that insolvency must be supported by well-pleaded facts. . . ." *Weiss v. e-Scrub Sys., Inc.*, NO. CV 13-710-GMS, 2014 WL 4680866, at *9 (D. Del. Sept. 19, 2014). A defendant should not be made to answer a claim and incur the expense of lay discovery and expert discovery, where, as here plaintiffs allegations are not only inadequate but are directly refuted by their own pleadings. To find otherwise would permit these Plaintiffs to use litigation to try to force the Directors to obtain the benefits of litigation based on allegations that, on their face, contradict any claim of insolvency.

It is not only proper, but essential to the integrity of the legal system, that a court refuse to allow a disgruntled shareholder or creditor to prosecute a costly derivative strike suit based on allegations that do not establish insolvency under any theory of Delaware law. *See Francotyp-Postalia*, 1998 WL 928382 at *5 (discussing the "flood of litigation" that will result from diluted pleading requirements in creditor derivative actions based on insolvency). For this reason, courts dismiss derivative claims with prejudice, where, as here, the allegations are baseless on their face. *See, e.g., Lightsway Litig. Servs., LLC v. Yung (In re Tropicana Entertainment, LLC)*, 520 B.R. 455, 472 (Bankr. D. Del. 2014) (finding complaint did not adequately plead insolvency); *Weiss*, 2014 WL 4680866, at *9.

The Opposition relies on *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014) for the proposition that the insolvency determination requires "fact intensive analysis that is not appropriate at the pleading stage." Opp. at 8-9. But *Quadrant* says nothing of the kind. The portion of *Quadrant* cited by Plaintiffs pertains to the imposition of trust based duty on officers' and directors' once the corporation is insolvent in real time, not whether the allegations alleged are sufficient to establish real time insolvency. In other words, *Quadrant* is merely reciting a relatively uncontroversial and settled proposition of Delaware law that "upon a corporation's insolvency, its

creditors gain standing to bring a derivative action . . . something they may not do if the corporation is solvent, *even if it is in the zone of insolvency*." *Id.*, at 102 A.3d at 172 (emphasis added). The reason for that is because once the "fact" of insolvency is established a "trust arises, and legality of the acts performed [by directors] will be decided by very different principles than in the case of solvency." *Id.* That has nothing to do with whether a plaintiff has pled facts sufficient to establish real time insolvency.

With respect to "Pleading insolvency," *Quadrant* found in an entirely different portion of the opinion, 102 A.3d at 176-177, that plaintiffs had pled sufficient facts to establish real time insolvency precisely because "[t]he complaint explains that in light of the *demise* of the credit product business model . . . *the Company has no realistic prospect of returning to solvency*." *Id.* at 177 (emphasis added). And to further support that allegation, "[t]he Complaint further explains that by the end of 2008" the company lost its AAA credit rating, and "by August 2010 the Company . . . no longer had any investment grade debt or counter party credit ratings." *Id*. Based on these well pleaded facts detailing the "demise" of the company's entire business model, its inability to obtain credit, and the existence of current real time deficits, "[t]hese facts adequately plead insolvency under the balance sheet test." *Id.*.

Unlike *Quadrant*, Plaintiffs here allege no facts, that if true, show that CC-PA is insolvent at this time under any theory or test. Plaintiffs expressly reference facts and documents which show positive cash flow and that CC-PA's financial stability is "beyond question" at this time. *See* FAC Ex. 2 at 4 & Ex. 5 at 1-2. There are no allegations of missed payments, overdue obligations, or negative cash flow. Accordingly, Plaintiffs have not and cannot allege insolvency under Delaware law and the court should dismiss the derivative claims without leave to amend. *See, e.g.*, *Lightsway Litig. Servs., LLC v. Yung (In re Tropicana Entertainment, LLC)*, 520 B.R. 455, 472 (Bankr. D. Del. 2014) (finding complaint did not adequately plead insolvency); *Weiss*, 2014 WL 4680866, at *9.

B. Plaintiffs Cannot Allege Insolvency Based On CC-PA's Balance Sheet Absent Allegations Showing That It Has No Reasonable Prospect Of Continuing To Operate.

Plaintiffs cannot obtain standing to pursue a derivative claim against CC-PA's directors based solely on allegations that the collective sum of certain contingent future liabilities exceeds the

value of current assets on the balance sheet. Plaintiffs must also allege facts showing that CC-PA has no reasonable prospects of successfully continuing its business into the future. Plaintiffs do not and cannot satisfy this critical element for pleading insolvency under Delaware law. The Opposition shows that Plaintiffs are not concerned about insolvency per se, but seek to use a hypothetical, paper balance sheet deficit to obtain relief — otherwise unavailable to them — to maintain claims intended to force CC-PA to alter its longstanding business model. *See* Opp. at 14:23-15:2. This is precisely the type of abusive "derivative" litigation that Delaware courts have tried to curb: litigation by disgruntled plaintiffs who seek to use the threat of "premature appointment of custodians and potential corporate liquidations" as a means to force companies like CC-PA to abandon an otherwise financially sound business model. *See Francotyp-Postalia*, 1998 WL 928382 at *5.

1. A Derivative Claim Based On Insolvency Requires Factual Allegations Establishing That CC-PA Has No Reasonable Prospects Of Continued Financial Survival.

Under Delaware law, a claim of insolvency requires facts showing that the target company has "no reasonable prospect that the business can be successfully continued" because of the alleged deficit. *Production Resources Grp. LLC v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004) (citation omitted); *see also N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Francotyp-Postalia*, 1998 WL 928382 at *5; *Quadrant*, 102 A.3d 177. Federal district and bankruptcy courts also employ the "reasonable prospects" pleading test when considering whether a balance sheet deficit renders an entity insolvent under Delaware law. *See, e.g., Weiss*, 2014 WL 4680866 at *9; *Lightsway*, 520 B.R. at 472; *Teleglobe USA, Inc. v. BCE Inc. (In re Teleglobe Communications Corp.)*, 392 B.R. 561, 599 (Bankr. D. Del. 2008).

Plaintiffs' contention that insolvency can be pled "when a company's liabilities exceed its assets ignores the realities of the business world in which corporations incur significant debt in order to seize business opportunities." *Francotyp-Postalia*, 1998 WL 928382 at *5. Facts showing that the collective amount or sum of future contingent liabilities exceeds current assets are insufficient to establish insolvency under Delaware law. *Id. See also Production Resources*, 863

A.2d at 782; *Weiss*, 2014 WL 4680866 at *9; *Lightsway*, 520 B.R. at 472; *Teleglobe USA, Inc. v. BCE Inc. (In re Teleglobe Communications Corp.)*, 392 B.R. 561, 599 (Bankr. D. Del.

2. Plaintiffs Fail To Plead Any Facts That Could Plausibly Establish That CC-PA Has No Reasonable Prospects Of Survival.

As Plaintiffs appear to concede, they cannot allege essential facts showing that CC-PA has no reasonable prospects of continuing to operate and meet its financial obligations as they become due in the foreseeable future. Nor can they. The documents referenced by Plaintiffs in the FAC show that CC-PA's continued success is "beyond question." *See* FAC Ex. 5 (Aug. 2, 2012 CDSS letter) at 1-2.[2] There is not a single allegation that CC-PA has ever missed or will miss a payment in the near future. And there are no allegations that CC-PA will not be able to promptly fill vacated units and obtain replacement entrance fees. "Despite the deficit on the actuarial balance sheet," the third party actuarial study on which Plaintiffs base their insolvency claim, shows that "all the evidence reviewed . . . supports Vi at Palo Alto's ability to remain a going concern." (DiGennaro Decl. Ex. A, Att. B at 2.) The authors of that study maintain that they have found "*nothing* that would call [into] question the community's ability to remain a going concern… and to fully perform its continuing care contract obligations." *Id.* at 1.

The collective face amount of the entrance fee repayments listed on the balance sheet provides no basis for asserting that CC-PA has no prospect of continuing to operate and meet payment obligations, including residents entitled to a return of their entrance fees. As Plaintiffs, concede, the repayment of entrance fee loans from residents are not presently due but will become due over a period of time that spans the life expectancies of the noteholders plus as much as 10 years to enable a sale of their unit. FAC ¶81. As a result, Plaintiffs have not provided a factual basis in the Complaint to conclude that CC-PA will be unable to make repayments from its then current assets, including assets obtained from the new entrance fees contracts for vacated units by current residents. *See generally Dye v. Communications Ventures III, LP (In re Flashcom, Inc.)*, 503 B.R.

[2] The Opposition quotes at length from the CDSS letter, but conspicuously omits these two sentences, which plainly illustrate the fallacies in Plaintiffs' insolvency argument. *Cf.* Opp. at 12-13.

99, 123 (C.D. Cal. 2013); *Sierra Steel, Inc. v. Totten Tubes, Inc. (In re Sierra Steel, Inc.)*, 96 B.R. 275, 279 (B.A.P. 9th Cir. 1989).[3]

3. Plaintiffs' Argument That Delaware Courts Have Abandoned The Reasonable Prospects Pleading Requirement Is Without Merit.

Unable to allege facts establishing that CC-PA has "no reasonable prospects" of continuing to operate, Plaintiffs offer a series of legal arguments intended to persuade the court that the allegation of a deficit on the balance sheet is sufficient to plead a claim for insolvency. In each argument, Plaintiffs insist that the pleading of a paper deficit is enough to allow them to engage in full blown discovery. These arguments are without merit.

First, Plaintiffs' place heavy reliance on *Quadrant* to argue that Delaware law eschews the reasonable prospects pleading requirement in favor of simple balance sheet pleading. Contrary to Plaintiffs' representations, the Delaware Court in *Quadrant* expressly recognized that the company's dire financial condition was sufficient to establish that "the [c]ompany has *no realistic prospect* of returning to solvency." 102 A.3d at 177 (emphasis added). *Quadrant* did not present a close case about insolvency. Among other things, the court noted that the company started with $100 million in equity capital, borrowed $600 million in the form of long-term debt, and then leveraged its equity capital another *500* times writing credit default swaps. *Id.* The company then made substantial payments, including one that exceeded six times its remaining equity capital, to unwind two unsuccessful swap transactions. *Id.* Based on these circumstances, the court found that the "great disparity between assets and liabilities," taken "in light of the demise" of the credit swap business model and depressed market conditions, established for pleading purposes that the company had no realistic prospect of returning solvency. *Id.* at 176-77.

Plaintiffs next contend that Delaware applies only the "reasonable prospects test" to start up companies. Plaintiffs are wrong. They mistake a court's consideration of a company's operational

[3] Plaintiffs' argument regarding the phrasing "whatever is left" on the note is a red herring. *Cf.* Opp. at 15. The Director Defendants' argument does not depend on any real or assumed amortization of the entrance fee loans, although the Residency Contract does in fact provide an amortization rate. *See* FAC Ex. 8, Appx. G at 1, ¶A ("The 'Amortization Rate' to be used when calculating any Repayment Amount due to You is two percent (2%) for each 'Month' after the Occupancy Date, as defined in Section 3.3.1").

status and history as a factor in evaluating the company's reasonable prospects of survival for a rigid rule that eliminates this fundamental pleading element in cases involving mature companies. None of the cases cited by Plaintiffs hold that the elements of a balance sheet insolvency claim are less stringent for a mature company than a start up. *See, e.g., Quadrant,* 103 A.3d at 176-77. Rather, the cases that discuss the distinction each considers the age and history of a company as one of many factors that can be considered in determining whether the allegations are sufficient to show no reasonable prospects of continued survival. In other words, the "reasonable prospect" test merely incorporates this as a factor under the law.[4] *See, e.g., Francotyp-Postalia,* 1998 WL 928382 at *5 (noting that it is common for Delaware corporations to operate with liabilities in excess of assets, especially, but not *only*, in the world of start-up companies).

Language quoted by Plaintiffs from *Quadrant* does not indicate otherwise. Opp. at 9. The quoted language comes from *U.S. Bank Nat'l Assoc. v. U.S. Timberlands Klamath Falls, LLC,* in which the court stated that "defendants are clearly right to argue that having liabilities in excess of the book value of assets is not dispositive of the issue of whether a company is insolvent." 864 A.2d 930, 948 (Del. Ch. 2004), *vacated on appeal,* 875 A.2d 632 (Del. 2005). While the maturity of the company is certainly one of many factors that a court may consider in determining the company's survival prospects, Plaintiffs fail to show that Delaware cases have adopted a different pleading standard for mature companies.

Third, Plaintiffs argue that the reasonable prospects test is not binding on this court because it was created by a lower state court in *Production Resources*. A fair reading of the case law shows that this argument is baseless. In *Gheewalla,* 930 A.2d 92 (Del. 2007), the Delaware Supreme Court confirmed the use of the "reasonable prospects" test. 930 A.2d at 98. And while that analysis was not required to adjudicate the case pending before it, there is no suggestion or implication that the

[4] Even if the "reasonable prospects" test was limited to immature companies, it would apply here. The FAC relies upon the Milliman Report, attached to the FAC as Exhibit 4, which concludes that CC-PA "is not yet mature." FAC Ex. 4 at 5; *see also id.* ("Over the long-term, as new residents replace existing residents, the contingent repayment liability on the balance sheet will decline. This did not happen in the last five years, despite the use of an 80% repayable contract since 2007, because Palo Alto *is not yet mature*") (emphasis added).

Supreme Court disagreed with or implied that reasonable prospects rule explained in *Production Resources* was not the law. *Id.* The judge who wrote the *Production Resources* decision is now the Chief Justice of the Delaware Supreme Court and, since *Gheewalla*, Delaware's federal district and bankruptcy courts have uniformly applied the "reasonable prospect" test to determine balance sheet insolvency under Delaware law. *See, e.g.*, *Weiss*, 2014 WL 4680866, at *9; *Lightsway*, 520 B.R. at 472. These courts have noted that it is "uncontroversial" that "the mere fact that [a company's] liabilities exceed its assets does not end the [insolvency] inquiry." *Production Resources*, 863 A.2d at 782-83; *see also Teleglobe*, 392 B.R. at 599.

In *Teleglobe*, the bankruptcy court considered the extent to which the reasonable prospects pleading requirement "adds an unreasonable qualifier to the basic definition of insolvency." *Id.* In addition, the court considered the plaintiffs' other argument that the application of a "reasonable prospects" test in *Production Resources* was limited because that case involved the appointment of a receiver, not plaintiff standing to pursue derivative claims. *Id.* The court disagreed on both points ruling that *Production Resources* controlled the rights of creditors in determining when a firm has reached the point of insolvency. *Id.* In so doing, the court noted that both Third Circuit precedent, as well as Delaware case law, provides that proof of "no reasonable prospects" is a fundamental element of a balance sheet insolvency claim under Delaware law. *Id.*

C. Plaintiffs Allegations Of Balance Sheet Insolvency Also Fail Because The Entrance Fees Are Not Presently Due.

Plaintiffs allegations that CC-PA is insolvent because of the alleged deficit on its balance sheet fails for the additional reason that they have not accounted for the contingent and temporal aspects of the entrance fee payment obligations. They treat the full balance of the loans as if they were all presently due. They fail to allege what the present value of those loans would be when discounted for future payment. Plaintiffs silence on this pleading issue is telling because the FAC concedes that (1) none of the entrance fees are due to be repaid now or in the immediate future; (2) the alleged repayment obligations will not all occur same time; and (3) repayment is based on the occurrence of contingent events that will occur at uncertain times in future, some 10-20 years down the road. *See* FAC ¶¶99-105 & Ex. 4.

In determining whether a deficit on a balance sheet shows insolvency, debts that are contingent on the timing of unknown future events must be reduced to their present value. "To determine a contingent liability, one must discount it by the probability that the contingency will occur and the liability will become real." *Dye*, 503 B.R. at 123 (quotation marks omitted); *accord Sierra Steel*, 96 B.R. at 279. Thus, in analyzing the extent to which a balance sheet deficit is sufficient to prove insolvency under Delaware law, the "central question [is] when are these loans due?" *Francotyp-Postalia*, 1998 WL 928382, at *5.

The district court's analysis in *Dye* provides a good explanation of why the failure to allege the present values of contingent loan obligations and future assets are central to a balance sheet insolvency claim. In *Dye*, the trustee of a bankrupt internet provider appealed a balance sheet solvency finding by the bankruptcy court in connection with preference claims because the court excluded certain debts from its analysis of the debtors balance sheet at the time of the transfers. 503 B.R. at 121-122. The debts and liabilities excluded by the court arose from contingent bridge loan liabilities incurred by the debtor prior to its obtaining Series B financing. *Id.* at 107-08. In ruling that bankruptcy court correctly excluded the bridge loans from its balance sheet analysis because of the contingent nature of the liability, the district court stated that "'[a] contingent liability must be reduced . . . to its present or expected amount before a determination on insolvency can be made. To determine a contingent liability, one must discount it by the probability that the contingency will occur and the liability will become real.'" *Id.* at 123 (citation omitted). Consequently, the exclusion of the contingent bridge loan liabilities from the balance sheet in determining the date that the debtor truly became insolvent was correct because "'the probability that these notes would have to be paid from the company's assets was extremely low.'" (*Id.* at 123.) (citation omitted).

That rationale applies with equal force in this case. The fact that CC-PA allegedly booked its future, contingent repayment obligations as liabilities on its balance sheet is not the same as alleging that the present value of those liabilities is equal to the total sum of collective face value of all outstanding entrance fees. Because Plaintiffs make no attempt to compare the present value of the loans with current assets, they have not properly pleaded balance sheet insolvency.

D. The Court Should Consider Extrinsic Documents Refuting Plaintiffs' Mischaracterization Of Documents Relied On In Their Pleadings.

Plaintiffs rely in substantial part on the Milliman Report to show insolvency. But, when put in proper context, such reliance is disingenuous and misleading. As its author explained, the Milliman Report did "not discuss or define 'solvency'" at all. DiGennaro Decl. Ex. A, Att. B at 1. It focused only on "the notion of 'satisfactory actuarial balance' related to the three tests performed in an actuarial study." *Id.* As a result, the Report analyzed the balance sheet for an entirely different purpose than determining solvency and, in so doing, used entirely different criteria than that used to analyze a balance sheet insolvency under Delaware law. *Id*. The author of the Milliman Reports specifically informed plaintiffs that the Report does "not mean that the community is insolvent or in imminent danger of becoming insolvent," and "should not be interpreted to imply that it is." *Id.*

Faced with the truth about what the Milliman Report really means, Plaintiffs argue that the Court should ignore the author's written clarification about its significance because it requires "references to extrinsic material." *See* Opp. 15; *see also* Plaintiffs' Opp. to Defendants' Request for Judicial Notice and Objections to Evidence at 4-5. The court's consideration is proper because the extrinsic materials relate directly to issues put in play by the Complaint, including documents that form the basis of Plaintiffs' insolvency allegations. Plaintiffs cannot be permitted to rely on the report when they know that the author did not intend it to be construed as they claim.

When ruling on a motion to dismiss, the Court may consider material submitted as part of the complaint or relied upon in the complaint. *Lee v. City of Los Angeles*, 250 F.3d 668, 688 (9th Cir. 2001). If the documents are not physically attached to the complaint, they may still be considered, where, as here, the authenticity is not contested and the truth of allegations that form the basis of the claim necessarily rely on or incorporate the documents. *Id.* This includes companion documents necessary to evaluate "the context in which the statement appeared" because the Court "must take into account 'all parts of the communication that are ordinarily heard or read with it.'" *Knievel v. ESPN*, 393 F.3d 1068, 1076 (9th Cir. 2005) (quoting Restatement (Second) of Torts §563, cmt. d (1977)).

The Ninth Circuit has extended the "incorporation by reference" doctrine "to situations in which the plaintiff's claim depends on the contents of a document, the defendant attaches the document to its motion to dismiss, and the parties do not dispute the authenticity of the document, even though the plaintiff does not explicitly allege the contents of that document in the complaint." *Id.* at 1076 (citation omitted). *See also Parrino v. FHP, Inc.*, 146 F.3d 699, 706 (9th Cir. 1998), *superseded by statute on other grounds*, 443 F.3d 676 (9th Cir. 2006) (holding that the district court properly considered documents attached to a motion to dismiss that described the terms of plaintiff's group health insurance plan and where plaintiff alleged membership in the plan).

The good faith pleading requirements under the Federal Rules further support consideration of documents clarifying those referenced in a complaint. The rules do not permit plaintiffs to selectively omit facts from their pleadings that refute or otherwise render their pleadings inaccurate.[5] This rule prevents plaintiffs from surviving a Rule 12(b)(6) motion by deliberately omitting references to documents upon which their claims are based. *Parrino*, 146 F.3d at 706. "Otherwise, a plaintiff with a legally deficient claim could survive a motion to dismiss simply by failing to attach a dispositive document on which it relied." *Pension Ben. Guar. Corp. v. White Consol. Industries, Inc.*, 998 F.2d 1192, 1196 (3d Cir. 1993), *aff'd*, 215 F.3d 407 (3d Cir. 2000).

Plaintiffs' contention that "much of the [Director Defendants'] arguments rely on "references to extrinsic material" is false. The Director Defendants rely on two documents: (1) the October 3, 2012 letter from CC-PA (the "CC-PA Response Letter") responding to the CDSS's August 2, 2012 letter, which is attached to the FAC as Exhibit 5 and quoted at length in the Opposition; and (2) the Milliman Letter, which expressly clarifies the Milliman Report (FAC Ex. 4) on which Plaintiffs base their insolvency allegations. Both of these documents clarify and define the meaning of the Report on which Plaintiffs rely. *Knievel*, 393 F.3d at 1076.

Plaintiffs base their insolvency argument on the conclusions in the Milliman Report and the August 2, 2012 CDSS letter. At the same time, they seek to exclude clarification of what those

[5] Plaintiffs also do not dispute that the documents were produced to them in October 2014. *See* Plaintiffs' Opposition to Defendants' Request for Judicial Notice and Objections to Evidence (ECF No. 74-3) at 4-5.

documents actually say. The Ninth Circuit is clear that Plaintiffs cannot cherry pick or selectively omit material from sources referenced in their complaint. *See Parrino*, 146 F.3d at 706. Here, it was Plaintiffs who injected material outside the pleadings by attaching no fewer than 38 exhibits to the FAC; they cannot now argue that the logical complement to those materials should be excluded. This is precisely the scenario the Ninth Circuit has sought to avoid by expanding the body of material that a court may consider in ruling on a motion to dismiss.

Finally, contrary to Plaintiffs' argument, this is not a case of two different experts disagreeing about the financial condition of CC-PA. Rather, this is simply a situation of ensuring that Plaintiffs are not permitted to pursue claims by mischaracterizing what the authors of the Milliman Report did and did conclude about CC-PA's financial state. These documents ensure that the court considers the Milliman Report in the manner that its authors intended. And once that is done, Plaintiffs' allegations that the deficit on CC-PA's balance sheet is sufficient by itself to satisfy the insolvency requirement necessary to assert a derivative claim under Delaware law fails as a matter of law and should be dismissed at the pleadings stage.

E. Plaintiffs Also Fail To Properly Plead Insolvency Under The Cash Flow Test.

Plaintiffs contention that their allegations plead that CC-PA is insolvent under the cash flow test suffers from the same defects as their balance sheet theory. Plaintiffs argument that because CC-PA allegedly does not possess sufficient funds to repay all of the entrance fee at this time, Plaintiffs have alleged with "convincing evidence" that CC-PA is insolvent under the cash flow test. Opp. 10 (citing FAC ¶102). There is no allegation — nor could there be — that CC-PA has ever failed to make a payment of any obligation of any type. The documents relied upon in the Complaint establish that CC-PA was cash flow positive in both 2012 and 2013 (FAC Ex. 2 at 6), and that it is projected to "remain positive over the ten year projection period," with slight negative balances in only three years. FAC Ex. 4 at 24. The Complaint also fails to take into account or to project the impact of rising prices for entrance fees of vacated units. Given the demand for the units, the location of the property and the rising real estate values in the area, the Complaint should have acknowledged and accounted for the fact that the sale of vacated units will likely deliver far

more cash than needed to pay off the entrance fee loans, meaning that cash will be available for other purposes. This reduces the potential need to obtain cash elsewhere.

But, even if there were a cash flow issue at the CC-PA level, an entity is not insolvent simply because it may rely on outside funding to pay its bills. *See Teleglobe*, 392 B.R. at 603; *Banks v. Cristina Copper Mines, Inc.*, 99 A.2d 504, 507 (Del. Ch. 1953). The fact that CC-PA may obtain funding from sources other than Plaintiffs' entrance fees does not change the analysis, other than to further expose the defects in Plaintiffs' insolvency allegations. Accordingly, Plaintiffs have not alleged insolvency under the cash flow test or balance sheet test and their derivative claim against the directors should be dismissed with prejudice.

IV. THE OPPOSITION FAILS TO REBUT THE GROUNDS FOR DISMISSING THE NON-DERIVATIVE CLAIMS AGAINST THE DIRECTOR DEFENDANTS.

A. All Of The Non-Derivative Claims Fail For The Reasons Stated In The Corporate Defendants' Reply Brief.

The Director Defendants join in and incorporate by reference the Corporate Defendants' reply brief with respect to the non-derivative claims and any documents filed in support thereof.

B. The Non-Derivative Claims Also Fail Because The FAC's Vague And Conclusory Allegations Are Not Sufficient To Allege Personal Liability On The Part Of The Director Defendants.

The Opposition fails to identify when and how each of the Director Defendants allegedly committed the misconduct underlying the non-derivative direct claims. Instead, Plaintiffs rely on Paragraphs 38-45, 106-111 and 156-184 of the FAC (Opp. 25), which merely allege the individual defendants' positions, that the board as a whole, without exercising due care, ratified actions taken by the corporation, and that the board acted in the interest of CC-DG. These allegations are insufficient to plead *non-derivative* claims against the Director Defendants because they are based on alleged harm to the *corporation* (CC-PA), not to Plaintiffs.[6]

Plaintiffs rely on *Silicon Knights v. Crystal Dynamics*, 983 F. Supp. 1303, 1316 (N.D. Cal. 1997) for the sufficiency of their pleadings, but the allegations in that case are materially different

[6] To the extent Plaintiffs' allegations suffice to state a claim against the Director Defendants at all, it would be a purely *derivative* claim alleging harm to the corporation. *See Production Resources*, 863 A.2d at 776 ("The fact that the corporation has become insolvent does not turn [derivative] claims into direct creditor claims, it simply provides creditors with standing to assert those claims.")

than what is alleged here. That complaint set forth "specific acts of fraud and misconduct," which the court held were sufficient under Rule 8 to state a claim for interference with contractual relations.[7] Here, the FAC does not allege any specific acts committed by any individual defendant—and in fact, does not even allege that each were officers or directors of CC-PA during the relevant time period. *See* Individual Defendants' Motion to Dismiss the First Amended Complaint ("MTD") at 21 & n.10. As the court recognized, "'[d]irectors and officers of a corporation do not incur personal liability for the torts of the corporation merely by reason of their official position. . . .'" 983 F. Supp. at 1308 (citation omitted).

C. The FAC Does Not Allege Any Specific Involvement, Wrongful Intent Or Knowledge On The Part Of The Director Defendants And Therefore Does Not State A Claim For Elder Abuse Against Them.

With respect to the elder abuse claim, the Opposition amounts to nothing more than a recitation of the statute and followed by a recitation of the FAC's vague allegations that "defendants" acted wrongfully. Opp. 26-27. The most Plaintiffs can allege about the Director Defendants is that they ratified the distribution of funds to CC-DG, allegedly leaving CC-PA underfunded and in a state of financial distress. *Id.* This is not enough to plead personal liability on the part of the Director Defendants for elder abuse.

One of the elements of elder abuse is that the plaintiff has been harmed. CACI No. 3100. This Court has already found that none of the Plaintiffs have been harmed (Order Granting Motion to Dismiss, ECF No. 55 at 10 ("Plaintiffs have not adequately shown an existing harm or an imminent harm in regards to their entrance fees such that they can establish an injury in fact")), and the documents attached to the FAC establish that any future harm is unlikely. *See* FAC Ex. 2 at 6 & Ex. 4 at 24-26. With respect to the monthly fees, the Court previously determined that the unambiguous language of the residency contracts contradicts Plaintiffs' alleged injury. ECF No. 55 at 12 ("The Residency Contracts signed by each Plaintiff clearly provides that monthly fees will be

[7] As discussed below, however, the allegations in *Silicon Knights* — though more specific than those here — were *not* sufficient to state a claim for fraud or negligent misrepresentation under Rule 9(b).

used to pay for general operating costs, insurance costs, and marketing costs. . . . [N]othing has occurred to run afoul of the contract terms"). Those contract terms have not changed.

Where no Plaintiff has been harmed and where cash balances are projected to remain largely positive over the next ten years, with a long waiting list for vacated units, the alleged distribution of funds to CC-DG could not possibly constitute elder abuse or assisting in elder abuse.

D. The Opposition Fails To Identify Any Specific Acts Of Concealment Or Misrepresentation On The Part Of The Director Defendants As Required Under Rule 9(b).

In support of the second, third and fifth causes of action for concealment, negligent misrepresentation and violation of Civil Code Section 1750, respectively, Plaintiffs allege that Defendants failed to disclose or misrepresented facts relating to CC-PA's alleged failure to maintain adequate reserves and alleged improper allocation of certain expenses to residents' monthly fees. FAC ¶¶86, 88, 90-95, 201-215, 229-237. These allegations are subject to a heightened pleading standard under Rule 9 of the Federal Rules of Civil Procedure. Fed. R. Civ. P. 9(b); *Lintz v. Bank of Am., N.A.*, No. 5:13-CV-01757-EJD, 2013 WL 5423873, at *5 (N.D. Cal. Sept. 27, 2013) ("In the Ninth Circuit, 'claims for fraud and negligent misrepresentation must meet Rule 9(b)'s particularity requirements'") (citation omitted). Plaintiffs do not cite a single case to the contrary.

In the *Silicon Knights* case, on which Plaintiffs hang their hats, the court actually *dismissed* the claims for fraud and negligent misrepresentation against the individual defendants, holding that while general allegations that the individuals "directed the alleged wrongful acts" were sufficient under Rule 8, they were not sufficient under Rule 9(b)'s heightened pleading requirement. *Silicon Knights*, 983 F. Supp. at 1316. To satisfy this heightened standard, a complaint must "'state the time, place, and specific context of the false representations, as well as the identities of the parties to the misrepresentations.'" *Id.* at 1315 (citation omitted). The "allegations of fraud [must be] specific enough to give defendants notice of the particular misconduct which is alleged to constitute the fraud charged so that they can defend against the charge and not just deny that they have done anything wrong." *Neubronner v. Milken*, 6 F.3d 666, 671 (9th Cir. 1993) (citation omitted).

In *Silicon Knights*,

> [n]one of the complaint's allegations of fraud state the time, place and manner of the alleged misrepresentations. Furthermore, only a few of

> the alleged misrepresentations identify the person who made the statement. Since fraud must be alleged in particularity, a general allegation that all Individual Defendants directed that the alleged fraudulent statements be made is insufficient to assert liability upon persons who did not make the statements. Additionally, there are no allegations upon which the Individual Defendants could be held personally liable for alleged omissions of material facts, since only Crystal Dynamics [the corporate defendant] was a party to the alleged contract. (983 F. Supp. at 1315)

The court dismissed the fraud and negligent misrepresentation claims. *Id.* at 1316.

The deficiencies in the FAC here are the same as those in the *Silicon Knights* case. Plaintiffs do not specify which of the Director Defendants, if any, participated in the alleged concealment and misrepresentations, or when they allegedly did so. *See* FAC ¶¶86, 88, 90-95. For example, Plaintiffs allege that "CC-PA never disclosed to Plaintiffs or the Class that it did not maintain cash reserves," and that "CC-PA expressly told incoming residents that the money they paid would remain at the Provider in Palo Alto." *Id.* ¶86. The FAC names only one person, Barry Johnson, an employee of Classic Residence Management LP, in connection with these allegations, and identifies only one specific conversation with a plaintiff or class member (although not the date of that conversation). *Id.* Nowhere do Plaintiffs allege that the Director Defendants themselves made any misrepresentations or omissions, directed CC-PA employees to make misrepresentations or omissions, or had any contact whatsoever with any plaintiff or class member. In fact, it is not even clear whether the alleged misrepresentations and omissions occurred while each of the Director Defendants held the position of director or officer of CC-PA. *See* FAC ¶¶38-43; *see also* MTD at 21-22.[8] As the court explained in *Silicon Knights*, "a general allegation that all Individual Defendants directed that the alleged fraudulent statements be made is insufficient to assert liability upon persons who did not make the statements." 983 F. Supp. at 1315. The same is true here.

There also is no allegation that any of the Director Defendants were a party to the residency contracts at issue—and the contracts themselves, which are attached to the FAC as Exhibits 8, 10, 12, 14, 16 and 18, demonstrate that they were not. Under *Silicon Knights*, this is fatal to Plaintiffs'

[8] Plaintiffs have no real response to the fact that some of the Director Defendants' dates of service do not match the timing of the alleged wrongdoing. *See* Opp. 28-29. The Opposition does not explain how the individual defendants (or the Court) can determine what they supposedly did wrong and when.

claims. The Director Defendants cannot be liable for concealment and negligent misrepresentation based on the alleged omission of material facts when they were never a party to the contract. *Id.*

The Opposition attempts to salvage Plaintiffs' fraud-based claims by asserting that Rule 9(b)'s particularity requirement is relaxed in cases involving corporate fraud. Opp. 28 (quoting *Estate of Migliaccio v. Midland Nat'l Life Ins. Co.*, 436 F. Supp. 2d 1095, 1106 (N.D. Cal. 2006)). But Plaintiffs misconstrue *Migliaccio*; the standard is relaxed only "in instances of corporate fraud *where* the facts supporting the allegation of fraud are exclusively within the defendants' possession." 436 F. Supp. 2d at 1106; *cf.* Opp. 28 (standard is relaxed *because* the facts are within defendants' control). *Migliaccio* recognizes that the relevant facts are not always within the defendants' exclusive control; in some cases, as here, the relevant facts—the contracts, promissory notes, ground lease, audited financial statements, marketing materials, corporate resolutions, correspondence with CDSS, and the Milliman Report—are all available to Plaintiffs and indeed are attached to the FAC. *See, e.g.*, FAC Exs. 2-6, 7, 8, 9, 20, 27, 28. There is no reason to "relax" Rule 9(b)'s stringent standards here. The Second, Third and Fifth Causes of Action should be dismissed.

E. The Director Defendants Do Not Owe Any Direct Fiduciary Duties To Plaintiffs, Who Are Creditors Of CC-PA; Recognizing A Duty Under These Circumstances Would Create An Untenable Conflict Of Interest.

The Opposition fails to cite any authority for the proposition that the directors of a corporation may simultaneously owe fiduciary duties directly to *both* the corporation's shareholders *and* its creditors. As the Delaware Supreme Court has explained, this would create an untenable conflict of interest and effectively disable directors from exercising their business judgment:

> Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. (*N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007))

The cases cited by Plaintiffs are inapposite. None involve *directors*, whose fiduciary duties are always owed to the corporation and its shareholders. *See id.* at 99 ("It is well established that the directors owe their fiduciary duties to the corporation and its shareholders") (citation omitted).

In *Migliaccio*, a life insurance company fraudulently induced plaintiffs into purchasing deferred annuities that mature after their actuarial life expectancies. The complaint stated a claim for breach of fiduciary duty because it contained "extensive allegations that [the defendant companies] 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 using standardized marketing materials and annuity contracts that defendants supplied." 436 F. Supp. 2d at 1108. The claims were not asserted against the defendant companies' officers or directors.

In re Nat'l Western Life Ins. Deferred Annuities Litig., 467 F. Supp. 2d 1071 (S.D. Cal. 2006), also involved an alleged scheme to defraud senior citizens into purchasing deferred annuities that were inappropriate for them. There, the sales agents allegedly held themselves out as objective financial planners who would act in the plaintiffs' best interests. *Id.* at 1087. This allegation, coupled with the fact that senior citizens are a protected class and the annuities sold allegedly were complex financial instruments which the average person cannot understand, was sufficient to provide a basis for a "fiduciary-like" duty in that the insured must depend on the good faith and performance of the insurer when deciding whether to purchase a deferred annuity. *Id.* The fiduciary duty claim was not asserted against the defendant company's officers or directors.

In *Abbit v. ING USA Annuity & Life Ins. Co.*, 999 F. Supp. 2d 1189 (S.D. Cal. 2014), the plaintiffs alleged that the defendant corporation unlawfully targeted senior citizens by advertising indexed annuity contracts that purport to protect retirement savings while hiding an "undisclosed complex embedded derivative structure." *Id.* at 1192. The defendant allegedly designed its indexed-annuity products to "'systematically deprive ING annuity holders of retirement savings and earnings potential,'" *id.* at 1193 (citation omitted), and held itself out as the plaintiffs' financial services provider. *Id.* at 1199. The court found that the allegations plausibly stated a claim for breach of fiduciary duty, citing it as an 'exceptional case," in which the buyer relied on the seller and the seller recognized that reliance. . . .'" *Id.* (quoting *Comm. on Children's Television, Inc. v.*

General Foods Corp., 35 Cal.3d 197, 222 (1983)). But, the fiduciary duty claim was not asserted against the defendant company's officers or directors.

In *Tri-Growth Centre City v. Silldore, Burdman, Duignan & Eisenberg*, 216 Cal. App. 3d 1139 (1989), a lawyer allegedly used confidential information learned from a former client and business partner to usurp an opportunity to purchase real estate. *See id.* at 1150-53. The fiduciary duty at issue flowed from the attorney-client and partner relationships. *Id.*

Here, the most Plaintiffs allege is that CC-PA advertised the community as financially sound and secure, which it is.[9] There is no allegation that the Director Defendants held themselves out as Plaintiffs' financial planners or agents, or purported to act in Plaintiffs' best interests. The alleged fiduciary relationship between the Director Defendants and Plaintiffs rests solely on the Director Defendants' service as officers and directors of CC-PA. The FAC does not allege even a single personal interaction between any of the Director Defendants and Plaintiffs, much less a close and trusting relationship in which the Director Defendants undertook to act on behalf of Plaintiffs.

The Fourth Cause of Action should be dismissed with prejudice as to the Director Defendants.

F. The Opposition Demonstrates That Plaintiffs Cannot State A Claim For Declaratory Relief Against The Director Defendants.

The Opposition states that Plaintiffs are entitled to declaratory relief "addressing, among other things, the refundable nature of the contracts under Health & Safety Code Section 1771(r)(2), and the applicability of the reserve requirement of Health & Safety Code Section 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

[9] The material attached to the FAC contradicts the allegation that CC-PA is not financially sound and secure. *Compare* FAC ¶¶5, 7, 17 ("Plaintiffs and the Class were informed that CC-PA was a reputable company that had the financial ability to refund their Entrance Fees, and that their investments would be secure"), 92, 93 *with id.* Ex. 5 (Aug. 2, 2012 CDSS letter) at 1-2 ("The issue arising from CC-PA's financial reports is not whether CC-PA has been successful financially or whether Vi at Palo-Alto's business model is sound. CC-PA's success and business model are beyond question"); *id.* Ex. 4 at 24 (cash balances are "projected to remain positive over the ten year projection period," with slight negative balances in only three years); *id.* Ex. 2 at 6 (audited financial statements showing net positive cash flow in 2012 and 2013).

whether they would be responsible for a multi-million dollar deductible if there were significant earthquake loss [sic]." Opp. at 22; *see also id.* (characterizing the claim for declaratory relief as regarding the interpretation of a contract and the parties' respective rights and obligations arising under that contract). Nowhere does the FAC allege the Director Defendants are a party to the residency contracts, which are the contracts at issue here. *See, e.g.*, FAC ¶¶261-267 (breach of contract cause of action asserted against CC-PA only). The purported controversies to be settled by a declaratory judgment have everything to do with interpretation of that contract and nothing to do with the individual Director Defendants—as is the case with respect to the FAC as a whole. The Tenth Cause of Action should be dismissed for this reason, as should the other claims against the Director Defendants.

CONCLUSION

For the foregoing reasons, the Director Defendants respectfully request that the Court dismiss with prejudice all claims against them.

Dated: April 20, 2015

ARNOLD & PORTER LLP

By: ***/s/ Gilbert R. Serota***
GILBERT R. SEROTA
PETER OBSTLER
DIANA D. DIGENNARO

Attorneys for Defendants PENNY PRITZKER, NICHOLAS PRITZKER, JOHN POORMAN, GARY SMITH, STEPHANIE FIELDS AND BILL SCIORTINO