Filed 2/27/14 Kingoschu Family Partners v. Public Storage CA2/8

**NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS**



IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION EIGHT

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| KINGOSCHU FAMILY PARTNERS, LLC, et al.,<br><br>Plaintiffs and Appellants,<br><br>v.<br><br>PUBLIC STORAGE et al.,<br><br>Defendants and Respondents. | B246469<br><br>(Los Angeles County Super. Ct. No. EC056309) |

APPEAL from the judgment of the Superior Court of Los Angeles County. Jane L. Johnson, Judge. Reversed.

Wolf Haldenstein Alder Freeman & Herz, Francis M. Gregorek, Betsy C. Manifold, Rachele R. Rickert, Marisa C. Livesay, Patrick H. Moran; Abraham, Fruchter & Twersky, Ian D. Berg and Takeo A. Kellar for Plaintiffs and Appellants.

Wachtell, Lipton, Rosen & Katz, William Savitt, Adam M. Gogolak; Irell & Manella, Craig Varnen and Claire O'Sullivan for Defendants and Respondents Public Storage and PS Orangeco Partnerships, Inc.

Freeman, Freeman & Smiley, Bradley D. Ross and Dawn B. Eyerly for Defendant and Respondent B. Wayne Hughes.

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Plaintiffs Kingoschu Family Partners, LLC and others commenced a class action on behalf of "similarly situated" limited partners against defendants Public Storage, PS Orangeco Partnerships, Inc., and B. Wayne Hughes, alleging breach of fiduciary duty and other causes of action. Plaintiffs were the limited partners in five partnerships, of which defendant Public Storage was a general partner. Defendant Hughes was a general partner in three of the partnerships, and a former Public Storage executive, and he owns 16 percent of Public Storage's common stock. PS Orangeco is a real estate investment trust and a subsidiary of Public Storage.

According to the complaint, defendants "squeezed out" the limited partner plaintiffs when defendant Public Storage acquired the partnerships at the "lowest possible price," based on a flawed valuation of the partnerships' worth. Defendants demurred to plaintiffs' first amended complaint, contending that plaintiffs lacked standing because their claims were derivative, not individual, and that plaintiffs were divested of their interests in the partnerships because the partnerships had already merged into Public Storage when plaintiffs sued. Defendant Hughes also argued the complaint was uncertain because it referred generally to "defendants," yet Hughes was a general partner in only three of the partnerships. The trial court agreed that plaintiffs lacked standing and sustained defendants' demurrers without leave to amend.

We find plaintiffs have asserted an individual claim, and that discovery can clarify any uncertainty as to Hughes, and we reverse.

## FACTS

Between 1976 and 1978, Public Storage organized investments by various individuals and entities in five partnerships formed for the purpose of owning and operating self-storage facilities. These partnerships paid quarterly cash contributions to their general and limited partners, and were extremely profitable. Public Storage was a general partner in each of the five partnerships. Hughes was the founder of Public Storage, chairman of its Board of Directors and its former CEO, and he was also a general partner in three of the partnerships. Over the years, Public Storage purchased a majority interest in each of the partnerships. Collectively, Hughes and PS Orangeco

Partnerships, Inc., a subsidiary of Public Storage, and Public Storage had the right to vote over half the shares of the partnerships by July 2011.

In January 2011, Hughes approached Public Storage about selling all of his interests in the partnerships to Public Storage. Public Storage concluded that it would benefit from the acquisition of the partnerships, and its board of trustees approved the mergers, with the goal of maximizing value for Public Storage shareholders. In July 2011, defendants announced that they intended to liquidate plaintiffs' partnership interests, and transfer ownership of the partnerships to Public Storage. Because Public Storage had acquired a majority interest in each of the partnerships, this could be accomplished without plaintiffs' votes. Plaintiffs were given the option to receive cash for their shares, or to receive an equivalent amount of Public Storage stock. However, both of these options resulted in less compensation for plaintiffs than their quarterly distributions from the partnerships. The transactions were consummated on August 23, 2011.

The first amended complaint alleges that defendants breached their fiduciary duties to plaintiffs when they consummated these transactions.[1] Plaintiffs claim the price received was unfair and undervalued their interests in the partnerships. Specifically, plaintiffs allege that the price was arrived at by relying on a flawed appraisal and fairness opinion. Robert A. Stanger & Co. issued the fairness opinion, and it is a longtime associate of Public Storage. The appraisal, on which the fairness opinion relied, was issued by Cushman & Wakefield Western Inc., another longtime Public Storage associate. The appraisal relied on flawed capitalization rates, and therefore significantly undervalued the partnerships.

Moreover, the transactions were plagued by conflicts. In the July 2011 information statement filed with the Securities and Exchange Commission by Public Storage (which announced the mergers), Public Storage admitted that it and Hughes had

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[1] Plaintiffs asserted other claims in their first amended complaint which they have abandoned on appeal.

significant conflicts of interest in connection with the mergers, and that absent these conflicts, the " 'terms of the mergers may have been more favorable to' " plaintiffs. Public Storage admitted that it had an interest in acquiring the partnerships at the lowest possible price, and that it did not solicit other offers for the partnerships, which might have resulted in plaintiffs receiving a higher price for their interests. Also, the mergers did not result from arm's length negotiations, and Public Storage did not "hire[] independent persons to negotiate the terms of the mergers for [plaintiffs]. If independent persons had been hired, the terms of the mergers may have been more favorable to [plaintiffs]." Also, the sale would benefit the Hughes family because they would be selling significant illiquid interests in the partnerships. Public Storage would benefit by receiving all of the interests in the partnerships, and by eliminating administrative expenses related to operating the partnerships.

Public Storage and PS Orangeco together demurred to the first amended complaint, arguing that plaintiffs lacked standing to bring their claims, as the claims alleged harm to the partnerships, and therefore were derivative in nature. These defendants also asserted that the claims were barred by the business judgment rule. Hughes demurred on the basis of standing, and on the basis that the first amended complaint was uncertain as to him, because only general partners owe fiduciary duties to the limited partners, and he was a general partner in only three of the partnerships. The trial court agreed that plaintiffs lacked standing and sustained the demurrers, without leave to amend. The court, nevertheless, requested supplemental briefing on whether the first amended complaint stated a cause of action for breach of fiduciary duty. The parties submitted supplemental briefs, and the trial court issued a notice of ruling finding that the claims remained uncertain as to Hughes, but that the first amended complaint adequately stated a cause of action for breach of fiduciary duty.[2]

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[2] The trial court acknowledged that these elements of its ruling were unnecessary, as the standing issue disposed of the first amended complaint in its entirety, but the court nevertheless addressed the other arguments raised by the demurrers to facilitate appellate review.

## DISCUSSION

A demurrer tests the legal sufficiency of the complaint. We review the complaint de novo to determine whether it alleges facts sufficient to state a cause of action. For purposes of review, we accept as true all material facts alleged in the complaint, but not contentions, deductions or conclusions of fact or law. We also consider matters that may be judicially noticed. (*Blank v. Kirwan* (1985) 39 Cal.3d 311, 318; *McKell v. Washington Mutual, Inc.* (2006) 142 Cal.App.4th 1457, 1491.) When a demurrer is sustained without leave to amend, "we decide whether there is a reasonable possibility that the defect can be cured by amendment: if it can be, the trial court has abused its discretion and we reverse; if not, there has been no abuse of discretion and we affirm." (*Blank, supra*, at p. 318.)

### 1. Standing

Defendants contend the first amended complaint states a derivative claim for breach of fiduciary duty, because "the crux of the [plaintiffs'] theory is that the Partnerships' assets were undervalued in the appraisals, which resulted in insufficient merger consideration for their partners." Plaintiffs maintain that their claim is individual, stemming from the alleged harm to their equity interests in the partnerships. We agree with plaintiffs, and conclude that they did not lose standing to bring their claim after the mergers were completed.

The California Supreme Court has clearly laid out the difference between individual and derivative causes of action. (*Jones v. H. F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 106-107 (*Jones*).) An individual action is " 'a suit to enforce a right against the corporation which the stockholder possesses as an individual.' [Citation.]" (*Id.* at p. 107.) An action is derivative if " 'the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any severance or distribution among individual holders, or it seeks to recover assets for the corporation or to prevent the dissipation of its assets.' [Citations.]" (*Id.* at p. 106.) The purpose of a derivative action is to allow shareholders or partners to enforce a claim that the partnership possesses, but which the partnership refuses to enforce. (*Ibid.*) Partners lose

standing to bring a derivative action when they no longer own shares in the partnership. However, individual claims may still be maintained. (See *Favila v. Katten Muchin Rosenman LLP* (2010) 188 Cal.App.4th 189, 214.)

In *Jones*, the majority shareholders of a savings and loan created a second holding company, transferred their controlling block of shares in the savings and loan to the holding company, and received a majority of the holding company's shares. (*Jones*, *supra*, 1 Cal.3d at pp. 105, 113.) The minority shareholders of the savings and loan were excluded from participating in the holding company, but the savings and loan company's assets and earnings were pledged to secure the holding company's debt to the benefit of the majority shareholders. (*Id.* at p. 115.) The stock in the savings and loan became unmarketable, and the majority shareholders refused to purchase the minority shareholder's stock at a fair price or to exchange the stock for an interest in the holding company. (*Id.* at p. 105.) Our Supreme Court held that the plaintiff had stated an individual claim because plaintiff "does not seek to recover on behalf of the corporation for injury done to the corporation by defendants. Although she does allege that the value of her stock has been diminished by defendants' actions, she does not contend that the diminished value reflects an injury to the corporation and resultant depreciation in the value of the stock. Thus the gravamen of her cause of action is injury to herself and the other minority stockholders." (*Id*. at p. 107.)

In *Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 421 (*Everest*), a real estate limited partnership became a wholly owned subsidiary of a new entity. (*Id*. at p. 415.) The interests of the limited partners were cashed out, while the general partners retained their equity interests in the postmerger entity. (*Ibid*.) The assets of the limited partnership were later sold at a substantially higher value than that assigned to the cashed out interests of the limited partners, with the general partners achieving a greater return on investment than the limited partners. (*Id.* at p. 429.) The court determined that plaintiffs were individually harmed, either in the original undervaluing of their interests in the partnership or by the exclusion from participation in the postmerger entity. (*Ibid.*) The court found that "a limited partner may suffer an injury to its interest

without the occurrence of any injury to the partnership entity or to the partnership assets because the interest of a limited partner in a partnership is separate and apart from the partnership's ownership interest in its assets." (*Id*. at p. 428.) Moreover, the court concluded that the partnership suffered no harm because the assets of the partnership survived the transaction intact. (*Id.* at p. 429.)

Similarly, in *Crain v. Electronic Memories & Magnetics Corp.* (1975) 50 Cal.App.3d 509, 517, 522-523 (*Crain*), EMM, the majority shareholder, acting through the defendant-directors, conspired to dispose of the corporation's assets in such a way as to ensure that EMM received the largest possible financial benefit, without regard to the financial consequences visited upon the minority shareholders. Because the claim alleged harm to the minority shareholders, rather than the corporation's ownership interest in its assets, the court held that the suit was individual. (*Id.* at p. 522.)

In contrast, in *PacLink Communications Internat., Inc. v. Superior Court* (2001) 90 Cal.App.4th 958, 965-966 (*PacLink*), the court held that the plaintiff limited liability company (LLC) members' action was derivative where the assets of the LLC were transferred fraudulently. The assets of the LLC were transferred to a new company, in which plaintiffs had no involvement, without any payment to the LLC. (*Id.* at p. 964.) Any injury to the plaintiffs was deemed to be incidental to the harm caused to the LLC itself, "[b]ecause the members of the LLC hold no direct ownership interest in the company's assets, [therefore] the members cannot be directly injured when the company is improperly deprived of those assets." (*Id.* at p. 965.) Plaintiffs claimed that the transfer of the assets had caused a "diminution in the value of their membership interest in the [LLC]," but because this reduction in value was directly attributed to the reduction in value of the LLC's assets, the claim was deemed to be derivative. (*Id.* at pp. 965-966.)

The above principles establish that plaintiffs' first amended complaint states an individual rather than derivative cause of action for breach of fiduciary duty. Plaintiffs have alleged injury to themselves as individual owners of shares in the partnerships rather than injury to the partnerships or partnership assets. (See *Jones*, *supra*, 1 Cal.3d at p. 107; *Everest*, *supra*, 114 Cal.App.4th at pp. 428-429; *Crain*, *supra*, 50 Cal.App.3d at p.

522.) In addition, recovery would compensate plaintiffs, rather than the partnerships themselves. As in *Everest*, this case involves the forced sale of plaintiffs' interests in the partnerships at an unfair price that is the gravamen of their cause of action. (See *Everest*, at p. 429.) Unlike *PacLink*, there is no claim the partnership was fraudulently depleted of its assets. Here, the assets of the partnerships were "passed unchanged to Public Storage at the close of the Liquidating Transactions." (See *Everest*, at p. 429.) As such, the assets retained their value with no dissipation or harm as a consequence of the merger. Consequently, the harm alleged by plaintiffs is individual rather than derivative.

Defendants contend the claim is derivative because the harm alleged is not unique to the plaintiffs. This assertion is misguided. *Jones* clearly states that the "individual wrong necessary to support a suit by a shareholder need not be unique to that plaintiff." (*Jones, supra*, 1 Cal.3d at p. 107.) The same injury may affect a substantial number of shareholders. So long as the individual injury is not incidental to an injury to the corporation or partnership, an individual cause of action exists. (*Ibid*.)

Accordingly, plaintiffs have standing, and the order sustaining the demurrer must be reversed.

**2. Business Judgment Rule**

Defendants also contend that their conduct is insulated from judicial second-guessing by the business judgment rule. "The business judgment rule is essentially a presumption that corporate directors act in good faith. . . . 'The business judgment rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions. . . . "The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest." ' " (*Kruss v. Booth* (2010) 185 Cal.App.4th 699, 728.)

The business judgment rule does not apply when there are conflicts of interest, or when actions are taken without reasonable inquiry or with an improper motive. (*Kruss v. Booth*, *supra*, 185 Cal.App.4th at p. 728.) Here, the complaint alleges that the

transactions involved significant conflicts of interest. Public Storage, and Hughes as a public storage stockholder and director, had an interest in acquiring the partnerships for the lowest possible price (and so stated in the Information Statement filed with the Securities and Exchange Commission) which was in conflict with the interests of the limited partners. Since we must accept the truth of the alleged conflicts of interest and the concomitant inference of self-dealing for purposes of deciding whether the demurrer was properly sustained, the business judgment rule does not support the judgment of dismissal. (*Ibid*.)

**3. Uncertainty**

Lastly, Hughes contends the first amended complaint is uncertain, because he was not a general partner in three of the partnerships, and the complaint fails to differentiate among the defendants on the basis of their respective partnership interests. Hughes argues the trial court sustained his demurrer on uncertainty grounds, but granted leave to amend. He contends that because plaintiffs did not amend their complaint, they have conceded that the defects cannot be cured. (See *Gutkin v. Univ. of SO. Cal.* (2002) 101 Cal.App.4th 967, 981 ["When a plaintiff elects not to amend after the court sustains a demurrer with leave to amend, we assume the complaint states as strong a case as possible, and we will affirm the judgment if the unamended complaint is objectionable on any ground raised by the demurrer."].) However, the demurrers were sustained, without leave to amend, on the ground that the plaintiffs lacked *standing*. Thus, the principle of conceded incurable defects does not apply here.

Demurrers for uncertainty are strictly construed, because discovery can be used for clarification. (*Khoury v. Maly's of Cal., Inc.* (1993) 14 Cal.App.4th 612, 616.) "There is no need to require specificity in the pleadings because 'modern discovery procedures necessarily affect the amount of detail that should be required in a pleading.' [Citation.]" (*Ludgate Ins. Co. v. Lockheed Martin Corp.* (2000) 82 Cal.App.4th 592, 608.) Therefore, a demurrer for uncertainty is appropriate only when a defendant cannot reasonably determine what issues or causes of action are stated. (*Khoury*, *supra*, at p. 616.)

Here, the first amended complaint adequately alleges that Hughes breached his fiduciary duties as a general partner in three of the partnerships by putting his own interests above those of the limited partners. Specifically, plaintiffs allege the transactions allowed Hughes to liquidate his stake of more than $54 million in the partnerships, and benefited him in his position as a Public Storage stockholder and insider. It is immaterial that he may not have breached any duty as to the other partnerships (or that the basis of any duty as to those partnerships may be unclear) because discovery can resolve any ambiguities regarding the basis and extent of Hughes's liability.

Accordingly, the cause of action for breach of fiduciary duty is adequately alleged as to all defendants.

**DISPOSITION**

The judgment is reversed. Appellants are awarded their costs on appeal.

GRIMES, J.

We concur:

BIGELOW, P. J.

RUBIN, J.