IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

SENIOR HOUSING CAPITAL, LLC, SHP ASSET MANAGEMENT, LLC, SHP SENIOR LIVING SERVICES, LLC, and SHP HEALTH CARE SERVICES, LLC,	)
Plaintiffs,	)
v.	)
SHP SENIOR HOUSING FUND, LLC, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, SOUTH PORT SQUARE, LLC, LAKE PORT SQUARE, LLC, REGENCY OAKS, LLC, HARBOUR HEALTH SYSTEMS, LLC, LAKE HARRIS HEALTH SYSTEMS, LLC, and SYLVAN HEALTH SYSTEMS, LLC,	)
Defendants.	) C.A. No. 4586-CS
SHP SENIOR HOUSING FUND, LLC, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, SOUTH PORT SQUARE, LLC, LAKE PORT SQUARE, LLC, REGENCY OAKS, LLC, HARBOUR HEALTH SYSTEMS, LLC, LAKE HARRIS HEALTH SYSTEMS, LLC, and SYLVAN HEALTH SYSTEMS, LLC,	)
Counterclaim Plaintiffs,	)
v.	)
SENIOR HOUSING CAPITAL, LLC, SHP ASSET MANAGEMENT, LLC, SHP SENIOR LIVING SERVICES, LLC, and SHP HEALTH CARE SERVICES, LLC,	)
Counterclaim Defendants.	)

MEMORANDUM OPINION
Date Submitted: February 26, 2013
Date Decided: May 13, 2013

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STRINE, Chancellor.

I. Introduction

This is the post-trial opinion in a protracted litigation between investors in a fund, SHP Senior Housing Fund (the "Fund"), formed to invest in retirement homes. Two of the plaintiffs, the former manager of the Fund, SHP Asset Management ("SHP") and its affiliate, held a 5% stake in the Fund. The main defendant, the California Public Employees' Retirement System ("CalPERS"), held the remaining 95% stake in the Fund. SHP and CalPERS signed the LLC Agreement creating the Fund in 2001, and in 2003 the Fund purchased three "independent living" senior housing facilities in Florida. In 2004, the Fund exercised an option to purchase three skilled nursing facilities that were contiguous to the senior housing facilities. The total investment in these facilities, which I term collectively the "Projects," was approximately $250 million, including assumed liabilities.

The LLC Agreement was to remain in place for 35 years, and was designed to reward SHP for creating long-term value for itself and CalPERS. Accordingly, the LLC Agreement provided that SHP would receive an "Incentive Distribution" at the end of 2007, and every seven years thereafter, based on how much the Projects had appreciated in value, and how much cash SHP had distributed to CalPERS and itself over the relevant "Calculation Period." The Calculation Period was defined as the period between the dates when Incentive Distributions were payable, or between the signing of the LLC Agreement and the date of the first Incentive Distribution. The capital appreciation of the Projects was to be determined by the price received for them, if they were sold, or based on their appraised "Fair Market Value," if they were not.

In addition to receiving an Incentive Distribution once every seven years, SHP was also entitled to receive a quarterly Asset Management Fee for managing the Projects, based on their fair market value. The LLC Agreement provided that if SHP withdrew as the Fund manager, it was entitled to have CalPERS buy out its Membership Interests in the Fund based on the Fair Market Value of the Fund's assets. Under separate Project-level agreements between CalPERS and SHP, SHP was entitled to Severance Compensation if it ceased to manage the Fund.

The market value of the Projects was appraised annually by appraisers selected by CalPERS. The contractual provisions setting forth the appraisal process were based on form contracts CalPERS uses in its relationships with various investment partners. Consistent with these forms, CalPERS had the right to select the appraiser who would value the Projects. CalPERS' form contracts did not provide for any judicial review of the appraisal that the appraiser produced.

Between 2003 and 2006, the appraised market value of the Projects increased dramatically, as Florida enjoyed a real estate boom. In 2007, CalPERS had the Projects appraised by the firm of Duff & Phelps as of the end of that year for the purpose of determining the Incentive Distribution. This Incentive Distribution would be payable on the date of SHP's withdrawal from the Fund, unless the parties agreed that it should be paid earlier. Under the values that were appraised at the end of 2007, CalPERS would have been liable to pay SHP over $40 million in an Incentive Distribution based off the capital appreciation alone. This was in addition to the component of the Incentive Distribution that would be based off the distributions of cash to CalPERS over the

Calculation Period. Although CalPERS was unhappy about the payout that would result from these appraisals, and registered an unexplained objection to SHP, it never made any substantive comments on the appraisals, and in January 2008 specifically authorized Duff & Phelps to issue the final versions of them. But CalPERS still balked at paying an Incentive Distribution based on these appraisals, which would be due, at the latest, when SHP withdrew as the manager of the Fund. CalPERS therefore pressured SHP to renegotiate the terms of the LLC Agreement. SHP was unwilling to accede to any terms that were less favorable than those that it already had, and believed that it was entitled to an Incentive Distribution based on the appraisals that CalPERS had commissioned. In June 2008, SHP gave CalPERS notice of its withdrawal from the Fund, effective December 2008.

Later in June, CalPERS ordered Duff & Phelps to revise its appraised estimates of the market values downwards. CalPERS then sought to replace the original 2007 appraisals with these revised appraisals. The LLC Agreement, however, provided no mechanism whereby CalPERS might replace the original 2007 appraisals with new ones that it liked better, and SHP refused to accept the new appraisals.

SHP's withdrawal from the Fund obliged CalPERS, in addition to paying the Incentive Distribution for the Calculation Period ending in 2007, to pay SHP for the value of its 5% Membership Interests, based on the Fair Market Value of the Fund in October 2008. Under CalPERS' form contract, the process for determining the value of the Membership Interests at the end of CalPERS' relationship with SHP was different from that used to determine the value of the Projects for the Incentive Distribution. If a party disagreed with the appraisals that were produced at the end of CalPERS' relationship with SHP, that party was permitted to request another set of appraisals from another appraiser that was pre-approved by CalPERS. These two sets would then be averaged, or, if the second appraisals differed by more than 5% from the first appraisals, the two appraisers would select a third appraiser from CalPERS' pre-approved list, which would also value the Projects. The final appraised value of the Projects would then be the average value of the appraisals that were within 5% of the middle value, or the middle value alone, if that was all that was left.

CalPERS obtained one set of appraisals of the Projects from Cushman & Wakefield. But, before it signed off on them, it pressured Cushman & Wakefield into adjusting them downwards. CalPERS then invoked the appraisal dispute process in the LLC Agreement and commissioned new appraisals. CalPERS pressured the new appraisal firm it hired, CB Richard Ellis, to produce low values. Because the CB Richard Ellis appraisals were more than 5% lower than the Cushman & Wakefield set, the two appraisers selected a new appraiser, who produced a third set.

SHP objected to CalPERS' invocation of the appraisal dispute process, on the grounds that CalPERS had put improper, bad faith pressure on Cushman & Wakefield in order to obtain a lower value for SHP's Membership Interests. SHP withdrew from the Fund in December 2008, but CalPERS did not pay it the Incentive Distribution or the Membership Interests. Nor did CalPERS pay SHP Asset Management Fees that were due to it under the LLC Agreement. And, CalPERS did not pay the Project operators, which were formed by SHP and are codefendants in this case, Severance Compensation that SHP claimed was due to them under separate Management Agreements.

In May 2009, SHP filed a complaint against CalPERS in this court, seeking to force CalPERS to pay an Incentive Distribution of approximately $52 million. Of this $52 million, over $40 million was attributable to capital appreciation, based on Duff & Phelps's original appraisals, and the remainder was attributable to distributions of cash to CalPERS. SHP also claimed a 5% Membership Interest of $2 million, based on the appraisals that Cushman & Wakefield produced, and Asset Management Fees, which were unpaid between October 2008 and December 2008, of $500,000. Under the Management Agreements that governed SHP's operation of the Projects, SHP claimed Severance Compensation of $1 million. In addition, SHP sought attorneys' fees, costs, and interest. In response, CalPERS counterclaimed, arguing that SHP demanded payment based on erroneous appraisals that valued the Projects too highly. CalPERS also alleged that SHP had abused the cash management system and wrongly extracted nearly $34 million.

The key issue in this case is what intensity of judicial review, *if any*, was contemplated by the LLC Agreement of the appraisals that CalPERS had done to determine the market values of the Projects for the purposes of the Incentive Distribution, the Membership Interests, and the Asset Management Fees. CalPERS, despite being the party whose form contract was used and despite having secured in that contract the unilateral right to select the appraisers, argues that the contractually determined appraisal value is entitled to almost no deference whatsoever. Rather, the court itself is to do the work of the appraisers from scratch and reach a *de novo* judgment as to the matters assigned to the appraisers by the contract.

SHP's position is the opposite of CalPERS'. SHP claims that this court may exercise almost no review of the appraisals. SHP points out that CalPERS controlled the appraisal process completely: it selected the appraisers to perform the appraisals, out of a pool of appraisers with which it had ongoing relationships, and set the standards for the appraisal. SHP notes that CalPERS and SHP were in the practice of giving the appraisers comments on the draft appraisals, but claims that once the draft appraisals were finalized, neither party had any right to object. Because of this, SHP argues that this court may not exercise *any* judicial review of the appraisals.

SHP's position is closer to the mark. Parties are entitled, within the bounds of regulatory law, to write contracts as they wish. They are free to require payments to be made in accordance with a contractual formula, and the role the courts have in determining whether the formula has been applied with fidelity is a subject the parties themselves are entitled to address. For example, the parties in this case could have opted to have a court determine the value of the Projects, either by not providing for any third party to provide a valuation for use in the formula, or by expressly providing that the value of the Projects would be determined by a court. In that circumstance, if the parties disagreed about what payment was due, the court would be required to hear evidence and decide which party was correct. As another option, the parties could have provided for resolution of the question of the appraisals of the Projects by appointing another appraiser to act as an arbitrator. In that circumstance, a reviewing court could only alter an appraisal according to standards in the Federal Arbitration Act—for example, if the appraisals were found to be the product of fraud, bias, or a math error.[1] As SHP points out, the parties here took the least judicially intensive approach possible. They did not provide for any substantive judicial review at all.

Where, as here, (i) a contract written by one party (ii) says that that party will make a payment based on a formula, (iii) the formula says that an input into the formula will be determined by an appraiser, and (iv) the party making the payment gets the contractual right to select the appraiser, the parties have clearly agreed to be bound by that appraiser's professional judgment. Unless the party unhappy with the appraiser's judgment can show that the appraised market value resulted from a concerted course of bad faith action between the appraiser and the other party—*i.e.*, a breach of contract by a party—or that the appraiser's result was otherwise tainted by the contractually improper conduct of the other party (such as intentionally providing the appraiser with false information to taint the valuation), the parties are stuck with what they bargained for. The lack of room for law-trained judicial second-guessing makes sense because such unschooled second-guessing undercuts the parties' choice to have an expert on the relevant property type perform the task.

Here, CalPERS bound SHP to receive an Incentive Distribution only if an appraiser CalPERS unilaterally chose determined that the Projects had a certain value. CalPERS' contention that it is entitled to a *de novo* appraisal is inconsistent with its own contractual words and framework.

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[1] *See* 9 U.S.C. §§ 10-11.

The resolution of this question is enough to decide much of the case in SHP's favor. Because the appraisals should not be disturbed under this standard, CalPERS' contentions fail. Nevertheless, both parties devoted much of their briefing to the very issue committed to the appraisers. The standard of review is a relatively novel one, and our Supreme Court may address it differently. Given that possibility, the parties' legitimate interest in having this dispute resolved definitively without further expensive proceedings weighs in favor of addressing this issue in the alternative. Likewise, judicial efficiency counsels in favor of this approach, while the evidence is fresh in the court's mind.

Senior housing communities are a unique type of property that present valuation challenges. In these communities, the residents pay a substantial entrance fee, which they usually fund by selling their house. For as long as they live in the community—which is usually until death—the residents pay a monthly fee. When the residents leave the community or die, half of the entrance fee is refunded to them or their estate. These refunds, together with the residents' ongoing right to receive services even if they are unable to keep paying a monthly fee, are termed the "resident liabilities," because they represent a liability to the Fund. But, from the point of view of the residents, they are an asset, and this asset is termed the "residents' interest" in the property, or the leasehold interest. The Fund's interest in the property is termed the leased fee interest. Together, the leasehold interest and the leased fee interest are generally taken to constitute the "fee simple" value of the property.

SHP consistently and persuasively argued that the standard practice in the industry is for the buyer of retirement communities to assume the resident liabilities. Thus, the buyer pays the leased fee value in cash, representing the value of the interest that the buyer is purchasing. All the appraisal firms estimated the market values of the Projects on this basis.

Over the course of the litigation, CalPERS adopted four different theories, but eventually settled on arguing that a buyer would demand some reduction off the leased fee value, or a “credit,” in return for assuming the resident liabilities. CalPERS’ arguments were confusing and unconvincing. Thus, even if I were not to enforce the parties’ contract, and I accepted CalPERS’ invitation to perform a *de novo* review of the appraisals, I would not adopt the appraisal methodology that CalPERS argues for, and I would still find in favor of SHP.

I find that CalPERS must pay SHP an Incentive Distribution based on the leased fee value that was appraised by Duff & Phelps in 2007. As to the Membership Interests, CalPERS must pay SHP for its 5% interest in the Fund based on the leased fee value that was appraised by Cushman & Wakefield. The dispute resolution mechanism in the LLC Agreement was not properly followed, and so I do not use the appraised value that came out of that process. And, because I find that CalPERS improperly coerced Cushman & Wakefield into reducing the appraised value, and thus breached its contractual duty of good faith and fair dealing, I modify the appraisals and reverse this reduction.

CalPERS must pay SHP its unpaid Asset Management Fees, based on the fee simple value—not just the leased fee value—in the original Duff & Phelps appraisals.

This is in accordance with the methodology that CalPERS and SHP used consistently for five years, before CalPERS changed its position just before the start of this litigation.

As a separate issue that affects the value of the Incentive Distribution, I find that SHP has not abused the cash management system, as CalPERS claims. Therefore, CalPERS must pay the Incentive Distribution that SHP demands in full.

CalPERS must also pay SHP Severance Compensation, as provided in the Management Agreements. CalPERS wants me to reform the Management Agreements so it can avoid paying Severance Compensation, but there is no proper basis for me to do so. CalPERS must pay SHP its attorneys' fees, because the LLC Agreement contains a fee-shifting provision. And, I grant SHP pre-judgment interest at the statutory rate. CalPERS has abandoned its independent counterclaims over the course of trial, and therefore I dismiss them.

II. Background

I now present the relevant history of the relationship between SHP and CalPERS.

A. CalPERS Decides To Coinvest With SHP In Senior Housing Projects

In 1998 and 1999, CalPERS began considering investing in senior housing facilities.[2] Because of demographic shifts in the population, CalPERS foresaw a boom in this market in the coming years.[3] CalPERS solicited expressions of interest from partners to invest in senior housing, and chose two partners, one of which was Shattuck Hammond

[2] JX 3 (memo from CalPERS Investment Office to members of CalPERS Investment Committee (Dec. 13, 1999)); JX 4 (memo from CalPERS Investment Office to members of CalPERS Investment Committee (Feb. 14, 2000)).
[3] JX 3; JX 4.

Partners, then a division of PricewaterhouseCoopers.[4] The team from Shattuck Hammond Partners was led by Craig Anderson.

After a drawn out process, CalPERS entered into an LLC Agreement with Shattuck Hammond Partners.[5] Certain key parts of it the Agreement were standard terms that CalPERS imposed on all its partners.[6] The structure of the parties' relationship was as follows. Shattuck Hammond Partners created two entities, SHP Asset Management, LLC ("SHP"), and Senior Housing Capital, LLC.[7] Together, SHP, SHC, and CalPERS were to coinvest in the "Fund," SHP Senior Housing Fund, LLC. This Fund would purchase senior housing facilities, or "Projects." CalPERS would have a 95.42% stake in the Fund, SHP would have a 0.2% stake, and Senior Housing Capital would have a 4.38% stake.[8] SHP was the Fund manager. SHP and Senior Housing Capital are two of the plaintiffs in this case; CalPERS and the Fund are two of the defendants. Unless there is any need to distinguish between the parties, I shall refer to the plaintiffs collectively as SHP, and to the defendants collectively as CalPERS.

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[4] *See* JX 17 (memo from CalPERS Real Estate Investment Office to Investment Committee (Oct. 16, 2000)).

[5] JX 28 (LLC Agreement (Mar. 16, 2001)) [hereinafter LLC Agreement]. The process was drawn out because PricewaterhouseCoopers had to divest itself of Shattuck Hammond Partners in order to resolve a conflict in its audit relationship with CalPERS. *See* JX 31 (letter from Michael Hammond, Shattuck Hammond Partners, to Lou Jug, CalPERS (Mar. 16, 2001)).

[6] *E.g.*, LLC Agreement Ex. Q (Statement of Equity Real Estate Appraisal and Valuation Policy).

[7] *See* JX 31 (letter from Michael Hammond, Shattuck Hammond Partners, to Lou Jug, CalPERS (Mar. 16, 2001)). Anderson bought out Shattuck Hammond Partners' interest in 2005. Anderson Dep. 31:7-18.

[8] LLC Agreement § 3.2(a)(i)-(ii).

CalPERS allocated $125 million to its investment with SHP.[9] The relationship between the parties was designed to encourage SHP to work in CalPERS' interest. In addition to SHP's coinvestment in the Fund, the LLC Agreement provided for an "Incentive Distribution" to be paid to SHP for increasing the Fund's value.[10] This Incentive Distribution, which is, in dollar terms, the biggest issue in the case, worked as follows. Every seven years, on specified "Calculation Dates," SHP would be entitled to a payout based on the returns achieved by the Fund since either the start of the Fund or the previous Calculation Date. The first Calculation Date was December 31, 2007. To receive a payout, SHP had to achieve "Excess Project Returns." These Excess Project Returns were defined as the Fund's internal rate of return, adjusted for inflation, over certain hurdle rates that varied according to the type of Project at issue. SHP could generate these excess returns in two ways. First, it could return cash, from the operations or sales of the Projects, to CalPERS. Second, at each Calculation Date, the "Fair Market Value" of the Projects was appraised by appraisers selected by CalPERS, and the Projects' Net Asset Value—defined as the Projects' Fair Market Value minus their debt, such as its mortgage—was "deemed" to be returned to CalPERS.[11]

Anderson and CalPERS deliberately chose this Incentive Distribution structure over other potential methods of aligning their interests, such as a payment of fees only when the Fund sold the Projects.[12] The LLC Agreement also provided for other

[9] *Id.*
[10] *Id.* Ex. H § 4.
[11] *Id.* § 1.1; *id.* Ex. H. § 4.
[12] *See, e.g.*, JX 25 (letter from Craig Anderson to Brian Bailey, CalPERS (Mar. 6, 2001)).

payments to SHP. First, SHP was entitled to annual Asset Management Fees of 0.6% of the first $400 million of the Fair Market Value of the Fund's interest in senior housing Projects, and of 0.4% of the Fair Market Value above $400 million.[13] Second, if SHP and Senior Housing Capital wished to withdraw from the Fund, CalPERS would purchase their interests in the Fund (the "Membership Interests").[14] The payments due to SHP were payable upon SHP's resignation as the manager of the Fund.[15] All of the Incentive Distribution, the Asset Management Fees and the Membership Interests are at issue in this dispute.

B. The Fund Buys Senior Housing Projects

SHP began looking for investment opportunities after it signed the LLC Agreement.[16] SHP's mandate was to invest in two kinds of projects: "Independent Living" Projects and "Continuing Care Retirement Communities" ("CCRCs").[17] Independent Living Projects are defined in the LLC Agreement as developments where residents receive board and lodging, and "not more than minimal" assistance with daily living activities.[18] CCRCs, on the other hand, are designed to provide care to almost all residents, no matter what their physical condition. The LLC Agreement defined CCRCs

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[13] LLC Agreement Ex. H § 2. The Fees were to be paid quarterly.
[14] *Id.* § 5.1(a).
[15] *Id.*
[16] *E.g.*, JX 37 (SHP Senior Housing Fund, LLC, Initial Annual Investment Plan (May 14, 2001)).
[17] *Id.*
[18] LLC Agreement § 1.1.

as being comprised of "independent living units, assisted living units, and units designed for providing skilled nursing care."[19]

By spring 2002, SHP had identified a potential acquisition target: three retirement communities in Florida owned by the Johnson Ezell corporation.[20] These properties consisted of independent living units, assisted living units, and skilled nursing beds.[21] But, SHP could not buy the assisted living and skilled nursing properties immediately, because CalPERS imposed high insurance requirements for these businesses.[22] Therefore, SHP proposed to CalPERS that it buy the independent living units, and take an option on the contiguous healthcare units, which would be purchased when CalPERS had secured insurance. CalPERS approved this transaction.[23]

At the start of 2003, SHP closed the transaction to purchase the independent living units. The three units were South Port Square in Port Charlotte, Florida;[24] Regency Oaks in Clearwater, Florida;[25] and Lake Port Square in Leesburg, Florida.[26] The purchases were made by Delaware limited liability companies owned by the Fund: South Port Square, LLC, Regency Oaks, LLC, and Lake Port Square, LLC.[27] These three limited liability companies are defendants in this case, along with CalPERS and the Fund.

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[19] *Id.*
[20] JX 45 (SHP Senior Housing Fund, LLC, Investment Committee minutes (Apr. 5, 2002)).
[21] JX 51 (SHP Senior Housing Fund, LLC, Investment Committee memorandum addendum (Oct. 25, 2002)).
[22] *Id.* at 4; Tr. 10:21-11:14 (Anderson).
[23] JX 56 (SHP Asset Management, LLC approval of Johnson Ezell transaction (Dec. 18, 2002)).
[24] JX 58 (South Port Square Asset Purchase Agreement (Jan. 31, 2003)).
[25] JX 59 (Regency Oaks Asset Purchase Agreement (Jan. 31, 2003)).
[26] JX 60 (Lake Port Square Asset Purchase Agreement (Jan. 31, 2003)).
[27] JX 58-60.

SHP paid $113 million in cash for these units, and—importantly—assumed another $132 million in liabilities as part of the purchase consideration.[28] The bulk of these liabilities stem from the residents' interest in the Projects, and how these liabilities are typically treated when the Projects are sold is a central subject of dispute between CalPERS and SHP. Thus, some explanation of the nature of these liabilities is necessary.

Up to May 2003, when a resident moved in to one of the Projects, she purchased a bond.[29] From May 2003 onward, this bond was replaced with an entrance fee.[30] This bond or entrance fee would often be funded by the sale of the resident's home.[31] In addition to buying the bond or paying an entrance fee, the resident would be liable for monthly occupancy fees.[32] In return for paying the monthly fee, the resident was entitled to receive board, lodging, nursing care, and the other services that the Project offered.

The economic substance of the bond and entrance fee programs was nearly identical, although the accounting treatment was different.[33] Under the entrance fee program, which was the "traditional" method of running retirement homes, the resident would pay an entrance fee to the home.[34] When the resident died or moved out, she would receive a refund of 50%, or more, of the entrance fee, depending on the amount of time she had spent in the home. If the resident ran out of money, and did not pay

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[28] *See* JX 148, at 10 (SHP Senior Housing Fund audited financial statements, 2002 and 2003).
[29] *See* JX 51, at 10.
[30] *Id.*; *see, e.g.*, JX 64 § 7(A) (sample Lake Port Square residency contract).
[31] Anderson Tr. 31:3-8.
[32] JX 64 § 7(B).
[33] *See* JX 148 at 9, 12-13.
[34] *Id.* at 13.

monthly rental fees, these would be offset from the refund.[35] The resident had the right to remain in the home even if the unpaid monthly fees exceeded the value of the refund of the entrance fee that she could expect.[36] Thus, the resident who paid an entrance fee had the right to remain in the Project until death, regardless of her financial situation.

Under the bond program, residents who moved in purchased a bond.[37] When the resident died or moved out, the bond was redeemed. The resident, or the resident's estate, then had to pay up to 50% of it to the retirement home, based on the length of time she had been in the home. As in the case of residents who paid an entrance fee, the resident had the right to remain in the Project until death, even if she stopped being able to pay the monthly fees; the unpaid monthly fees would be added on to the amount that the resident had to pay out of the proceeds from the bond redemption. The money that the residents were expected to pay out of the bond proceeds was the "occupancy fee receivable."

Because of the rights that they received from buying a bond or paying an entrance fee, the residents had a property interest in the Projects, as well as the Project owners.[38] The total value of the Projects, or the "fee simple" value, can be divided into the owner's interest, or "leased fee," and the residents' interest, or "leasehold."[39] The residents'

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[35] JX 64 § 12.
[36] *Id.* § 11(G).
[37] JX 148, at 8.
[38] *E.g.*, Tr. 1045:22-1046:4 (Boehm – Redirect).
[39] *Id.* As one industry expert noted in a letter to Craig Anderson, there may be unusual cases where the fee simple value will not equate to the sum of the leased fee and leasehold value. *See* JX 158 (letter from Alan Plush to Craig Anderson (May 13, 2004)). For the purposes of this opinion, it is sufficient to describe the total fee simple value as involving the total sum of the value of the leased fee and the value of the leasehold.

interest included the value of their expected entrance fee refunds and the money they expected to receive from the bond redemptions, and was termed the "resident liabilities." When SHP bought the Projects in 2003, it paid the buyer $113 million in cash, for the leased fee interest, but it also assumed $126 million in resident liabilities, plus other liabilities.[40]

By July 2004, the issue of insuring the related healthcare and assisted living Projects had been resolved, and CalPERS approved the exercise of the option to buy those Projects.[41] The Fund bought these Projects on July 30, 2004.[42] The Fund held the Projects through three Florida limited liability companies, Harbour Health Systems, LLC, Sylvan Health Systems, LLC, and Lake Harris Health Systems, LLC.[43] These three limited liability companies are also defendants in the action, along with CalPERS, the Fund, and the three other limited liability companies through which the Fund holds the Independent Living Projects.

C. SHP Uses The Cash Management System To Meet The Fund's Operating Requirements And To Make Distributions

The Fund began operating the Projects on February 1, 2003. The LLC Agreement provided that CalPERS and SHP would invest the necessary capital in the Fund in proportion to their respective membership shares.[44] Thus, SHP was to contribute 4.58% of all capital. Early in the relationship, however, CalPERS began funding all of the

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[40] JX 148, at 10.
[41] JX 176 (email from Julie Rost, CalPERS, to Craig Anderson (July 8, 2004)).
[42] JX 181 (draft Harbour Health Center, Lake Harris Health Center, and Sylvan Health Center management agreements).
[43] *See id.*
[44] LLC Agreement § 3.2.

Fund's cash requirements.[45] As SHP pointed out to CalPERS, this meant that CalPERS was owed 4.58% of all such funding as a capital contribution by SHP.[46]

CalPERS and SHP then agreed to a system by which CalPERS would continue funding all of the Fund's requirements. This agreement arguably represented a departure from the explicit terms of the LLC Agreement, because SHP was not making ongoing capital contributions. Under the understanding that the parties reached by email and put into actual practice, SHP set up "Due to" and "Due from" entries in the Fund's monthly financial statements. If the Fund had an operating shortfall in a given month, CalPERS would fund that shortfall, and 4.58% of the shortfall would be marked as an "other asset" that was "due from" SHP.[47] If the Fund had an operating surplus in the following month, SHP's 4.58% share of that surplus would be used to reduce the "Due from" amount.[48] If the "Due from" entry was entirely eliminated, a "Due to" entry would be entered instead, and the funds payable to SHP would be marked as a liability on CalPERS' balance sheet.

SHP obtained its funding from CalPERS' cash management system. The Fund had an account with Bank of America, which was swept daily into a collection account at Bank of America, and from there into an investment account with State Street Bank.[49] If the Fund needed cash, it could draw on its account at Bank of America, and the cash management system would automatically cover the shortfall. This simple mechanism worked well with the "Due to/Due from" arrangement that SHP agreed with CalPERS:

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[45] JX 78 (email chain between Andre Maksimow and CalPERS staff).
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *See* JX 1380 (Garvey Ex. 4 (CalPERS cash management system account structure)).

the Fund's cash needs were covered automatically. By the time SHP withdrew from the Fund, SHP owed CalPERS a total of $1.7 million under the "Due from" account.[50]

SHP was aware that it could increase the Incentive Distribution by making distributions of cash to CalPERS. SHP believed that, when the Fund generated income, any money in excess of contributions from CalPERS that was in the cash management system each month was considered a "Distribution" of cash as that term was defined for the purposes of the Incentive Distribution.[51] SHP consistently reported such Distributions on its monthly financial reports, just as it consistently reported contributions of cash from CalPERS.[52] SHP also knew that such Distributions did not follow the letter of the LLC Agreement, which provided that "[o]n a monthly basis, the Manager shall instruct the Bank of America to remit to CalPERS, SHP, and SHCLLC their respective portions of Cash Available for Distribution."[53] SHP did not consistently request Bank of America to remit money to CalPERS, using a cash flow form, when the Fund had generated money each month. Instead, it distributed cash on a cash flow form only in response to extraordinary events, such as when it paid out the proceeds of hurricane insurance.[54] Otherwise, ordinary distributions of cash in excess of the Fund's operating requirements were simply and plainly reported monthly to CalPERS as "Distributions."[55]

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[50] JX 1177 (Fund financial statements (Nov. 30, 2008)). SHP acknowledges that it must pay this money to CalPERS.
[51] JX 102 (email from Andre Maksimow to Craig Anderson (July 16, 2003)).
[52] *E.g.*, JX 182, at 6-8 (Fund financial statements, July 2004).
[53] JX 102; *see* LLC Agreement § 7.6.
[54] Anderson Dep. 36:16-37:6.
[55] *E.g.*, JX 182.

D. SHP Installs Its Subidiaries To Operate The Projects

When the Fund bought the Projects, it kept in place the operational management, which was the Johnson Ezell company. Johnson Ezell informed Anderson in October 2004 that it intended to resign as the manager of the Projects, effective April 2005.[56] SHP discussed with CalPERS how Johnson Ezell could be replaced. In January 2005, SHP proposed that it form its own captive management companies to operate the Projects.[57] SHP planned to retain the majority of the employees of the old operators.[58]

SHP estimated that, if it kept in place the same agreements with its new captive operator that it had had with Johnson Ezell, the new captive operator would lose money each year.[59] Therefore, SHP sought to create two new operators—one for the original independent living Projects and one for the more recently acquired health care Projects—that would be owned by the Fund.[60] In March 2005, CalPERS' Real Estate Unit rejected SHP's request that the Fund form its own captive operators.[61] Later, CalPERS rescinded that decision.[62] But, because there was a chance that the CalPERS Investment Committee might reject the decision of CalPERS' Real Estate Unit to allow the Fund to form new captive operators, SHP agreed to own the operators itself.[63]

SHP then created the two new captive operators, SHP Senior Living Services, LLC, and SHP Senior Health Care Services, LLC. These are plaintiffs in this action,

[56] JX 198 (letter from Neil Ezell to Craig Anderson (Oct. 12, 2004)).
[57] JX 221 (SHP Senior Housing Fund annual investment plan (Jan. 7, 2005)).
[58] *Id.*
[59] JX 244 (memo from Craig Anderson to Judy Alexander (Feb. 24, 2005)).
[60] *Id.*
[61] JX 266 (email from Judy Alexander to Mike McCook (Mar. 4, 2005)).
[62] JX 281 (memo from Craig Anderson to Judy Alexander (Mar. 20, 2005)).
[63] *Id.*

together with SHP and Senior Housing Capital, LLC. SHP Senior Living Services signed Management Agreements with the three limited liability companies that owned the original independent living facilities, *i.e.*, Regency Oaks, LLC, Lake Port Square, LLC, and South Port Square, LLC.[64] SHP Senior Health Services signed Management Agreements with the three limited liability companies that owned the health care facilities, *i.e.*, Harbour Health Systems, LLC, Lake Harris Health Systems, LLC, and Sylvan Health Systems, LLC.[65]

These Agreements provided that, if the companies that owned the Projects terminated the agreements without cause, the captive operators would be paid Severance Compensation.[66] Importantly, the Agreements provided that a change in the manager of the Fund would also be deemed a termination without cause.[67] The captive operators, who are owned by SHP, have sued the Project owners, owned by the Fund, to recover this Severance Compensation.

E. <u>CalPERS Has The Projects Appraised In 2003</u>

Under the LLC Agreement, CalPERS was required to appraise the value of the Projects annually.[68] The form of the appraisals was laid down by Exhibit Q of the Agreement, which was CalPERS' "Statement of Equity Real Estate Appraisal and

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[64] JX 298 (Regency Oaks Management Agreement (May 1, 2005)); JX 299 (Lake Port Square Management Agreement (May 1, 2005)); JX 300 (South Port Square Management Agreement (May 1, 2005)) [collectively hereinafter IL Management Agreements].
[65] JX 301 (Harbour Health Systems Management Agreement (May 1, 2005)); JX 302 (Lake Harris Health Systems Management Agreement (May 1, 2005)); JX 303 (Sylvan Health Systems Management Agreement (May 1, 2005)) [collectively hereinafter HC Management Agreements].
[66] IL Management Agreements § 3.05; HC Management Agreements § 3.04.
[67] IL Management Agreements § 3.02(D); HC Management Agreements § 3.02(D).
[68] LLC Agreement Ex. Q.

Valuation Policy." Exhibit Q provided that "[s]cheduling of appraisals within a given year shall be at the discretion of [CalPERS] Staff" and that "[CalPERS] Staff . . . shall select appraisers appropriate to perform valuations on the real estate investments."[69] Under Exhibit Q, it was not possible for any party to dispute the result of an appraisal, unless the appraisal was "at the end of a contract period."[70]

The appraised values had three uses. First, they were to determine the quarterly Asset Management Fees that were payable to SHP for managing the Fund.[71] Second, when the year end coincided with the end of the Calculation Period, as in 2007, they were to be used to calculate the Incentive Distribution.[72] Third, they were to be used to calculate SHP's Membership Interests if SHP elected to leave the Fund.[73] Despite the importance of the appraisal process, and the potential accounting difficulties caused by the residents' liabilities, neither CalPERS nor SHP had an agreed method of valuing the properties, and both independently requested advice from the same appraiser, Alan Plush, on how to value the Projects.[74]

Appraisals at CalPERS were handled by CalPERS' Performance Monitoring Unit. CalPERS had a rigorous selection policy for choosing appraisal firms. Certain firms would be chosen to be part of its "spring-fed pool," and, out of that pool, a firm would be

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[69] *Id.* Ex. Q § I.
[70] *Id.* Ex. Q § II.B.
[71] *Id.* Ex. H § 2.
[72] *Id.* Ex. H § 4.
[73] *Id.* §§ 4.7(c), 5.1(a).
[74] JX 38 (letter from Alan Plush to Tod Davis, CalPERS (May 18, 2001)); JX 158 (letter from Alan Plush to Craig Anderson (May 13, 2004)). In 2001, Plush worked at PricewaterhouseCoopers; by 2004, he had left PricewaterhouseCoopers and formed his own valuation business, HealthTrust. Plush Dep. 18:14-19:19.

chosen for a particular assignment.[75] Being part of the CalPERS appraisal pool was financially rewarding for the companies involved.[76]

In 2003, CalPERS retained American Appraisal Associates to appraise the Projects.[77] American found the appraisal process extremely challenging, and regretted underbidding for the work.[78] American appraised the market value of the leased fee estate of the properties, including the healthcare facilities (over which the Fund only had an option at that time), at $139 million.[79] Importantly, American valued the leased fee estate only, and explicitly stated that the buyer would be expected to assume the value of the resident liabilities.[80]

Under the LLC Agreement, there was no way for the parties to dispute the result of an appraisal, unless that appraisal was carried out at the end of the parties' relationship.[81] But, the parties understood that each side had the right to comment on draft appraisals, and request changes, before they were finalized. Thus, American discussed the 2003 appraisals with SHP before it sent the final reports to CalPERS,

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[75] Dennis Dep. 61:18; *see also* Tr. 373:2-8 (Enright).
[76] *E.g.*, Tr. 435:16-19 (Enright); *id.* 474:18-24.
[77] *See* JX 109 (American Appraisal Associates internal email (Oct. 10, 2003)).
[78] *Id.*
[79] *See* JX 123-25 (AAA reports for Lake Port Square, Regency Oaks, and South Port Square (Jan. 14, 2004)). Without the healthcare facilities, AAA appraised Fair Market Value at $127 million. *See id.*
[80] JX 117 (email from Michael Bates, AAA, to Craig Anderson (Dec. 30, 2003)) ("We assume that a prospective seller would require the buyer to assume these [*i.e.*, the resident bond and entrance fee] liabilities."); *see also, e.g.*, JX 122 (AAA report, Lake Port Square (Dec. 31, 2003)) ("The turnover cash flows and the appraisal assume that a prospective buyer would assume resident bond and entrance fee liabilities.").
[81] *See* LLC Agreement Ex. Q; JX 651 (letter from Al Grijalva to Fred Minnes (Jan. 10, 2008)).

whereupon CalPERS had the right to comment on them.[82] Throughout SHP's management of the Fund, the parties adhered to the principle that either could request the appraiser to make changes to the draft appraisals that the appraiser was free to consider in good faith, up until the point when CalPERS authorized the appraiser to issue final versions.[83]

After the appraisals were complete in January 2004, American refused to take part in future valuations, because it had lost money on its work.[84] American also felt that SHP had not informed it how complicated the businesses were, and that SHP had improperly applied pressure to attempt to get the appraised values increased before they were finalized, by arguing that American was underestimating the Projects' net operating income.[85] CalPERS, however, did not object to the valuation.

F. <u>SHP And KPMG Resolve The Accounting Issues Around The Projects</u>

In 2004, SHP and KPMG, the Fund's auditor, discussed how the value of the Projects should be reported on the Fund's balance sheet.[86] SHP and KPMG agreed that the resident liabilities should be included in the Fund's "Total Real Estate at Fair Market Value" because it was "customary for buyers to assume all liabilities for entrance fee refunds, resident bonds and comparable accounts."[87] SHP stated that it had an obvious

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[82] *See* JX 117.
[83] Tr. 392:23-393:5 (Enright).
[84] *See* JX 126 (email from Michael Bates to AAA team (Jan. 19, 2004)).
[85] *Id.*; *see also* JX 117 (email from Michael Bates to Craig Anderson (Dec. 30, 2003)) ("Most of the items noted in your email have the effect of increasing NOI . . . . Your management may be able to create a significantly higher value . . . over time . . . but to show a much higher value indication, in such a short time, [is] not def[e]ndable.").
[86] *See* JX 140 (memo from Craig Anderson to CalPERS (Apr. 7, 2004)).
[87] *Id.*

conflict of interest in this accounting matter, because this accounting change would increase the carrying value of the assets from $140 million to $286 million, which would increase SHP's Asset Management Fees.[88] CalPERS' Performance Monitoring Unit approved the accounting treatment, although the Investment Office refused to comment on the higher fees.[89] The Investment Office requested that SHP have Alan Plush, of HealthTrust, put in writing his conclusions of how the resident bonds should be valued.[90] Plush also delivered a set of valuations, of the fee simple estate of the independent living facilities only as of December 31, 2003, and appraised them at $259 million.[91]

G. CalPERS Has The Projects Appraised From 2004 To 2006, During The Florida Real Estate Boom

In 2004, CalPERS hired a different firm to carry out the appraisals, Integra Realty Resources. Unlike American, Integra valued the fee simple estate, not simply the leased fee. The total market value for the properties, including the health care units, was $308 million.[92] CalPERS retained Integra again in 2005. This time, Integra valued the market

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[88] *Id.*

[89] JX 147 (email from Henry Lam, Portfolio Monitoring Unit, to Craig Anderson (Apr. 8, 2004)); JX 152 (email from Julie Rost to Craig Anderson (Apr. 16, 2004)).

[90] JX 163 (email from Julie Rost to Craig Anderson (May 18, 2004)).

[91] JX 164 (South Port Square appraisal (May 18, 2004)); JX 165 (Lake Port Square appraisal (May 18, 2004)); JX 166 (Regency Oaks appraisal (May 18, 2004)).

[92] JX 216 (Regency Oaks appraisal (Jan. 3, 2005)); JX 218 (Lake Port Square appraisal (Jan. 7, 2005)); JX 224 (South Port Square appraisal (Jan. 10, 2005)); JX 229 (Sylvan Health Systems appraisal (Jan. 11, 2005)); JX 231 (Lake Harris Health Properties appraisal (Jan. 13, 2005)); JX 234 (Harbour Health Properties appraisal (Jan. 17, 2005)). Integra had also appraised the market value of the fee simple estate of the independent living properties, without the healthcare facilities, for Bank of America as of September 2004. Integra's value for that appraisal was $240 million. JX 190 (Regency Oaks appraisal (Sept. 23, 2004)); JX 192 (Lake Port Square appraisal (Sept. 24, 2004)); JX 193 (South Port Square appraisal (Sept. 24, 2004)).

value of the fee simple estate of all the Projects at $475 million.[93] Integra discussed these appraisals with SHP before they were finalized. SHP asked why Integra had increased the capitalization rates compared to the previous year, lowering the Projects' value, and also asked Integra to correct math and other errors that both understated and overstated future cash flows.[94]

In 2006, Integra again appraised the Projects. This time, it valued them at $516 million.[95] As before, SHP reviewed the appraisals and provided feedback before they were finalized.[96] According to these appraisals, the value of the Fund's leased fee interest in the Projects was nearly three times what it was at the end of 2003.[97]

2006 marked the peak of the real estate boom in Florida. According to the Case-Shiller house price index, house sales in Tampa (within 100 miles of all the Projects) peaked in July of that year, 64% higher than they had been in December 2003.[98] Other

[93] JX 371 (Sylvan Health Properties appraisal (Jan. 9, 2006)); JX 375 (Lake Harris Health Properties appraisal (Jan. 12, 2006)); JX 377 (Regency Oaks appraisal (Jan. 13, 2006)); JX 378 (South Port Square appraisal (Jan. 13, 2006)); JX 379 (Harbour Health Properties appraisal (Jan. 13, 2006)); JX 380 (Lake Port Square appraisal (Jan. 13, 2006)).
[94] JX 370 (email from Andre Maksimow to Craig Smith, Integra (Jan. 4, 2006)); JX 393 (email from Andre Maksimow to Craig Anderson (Jan. 30, 2006)).
[95] JX 488 (Regency Oaks appraisal (Dec. 18, 2006)); JX 490 (South Port Square appraisal (Dec. 19, 2006)); JX 491 (Lake Port Square appraisal (Dec. 22, 2006)); JX 493 (Lake Harris Health Properties appraisal (Dec. 28, 2006)); JX 497 (Sylvan Health Properties appraisal (Jan. 2, 2007)); JX 503 (Harbour Health Properties appraisal (Jan. 5, 2007)).
[96] *See, e.g.*, JX 514 (email from Enright to Integra (Jan. 18, 2007)).
[97] The 2006 Integra appraisals valued the leased fee interest in the Projects at $396 million, as compared to the $139 million valuation of the 2003 American appraisals.
[98] *See S&P/Case-Shiller Not-Seasonally Adjusted Home Price Index*, Standard & Poor's (Jan. 2013), http://www.standardandpoors.com/indices/articles/en/us/?articleType=XLS&assetID =1221192472066. A trial court may take judicial notice of facts that are not subject to reasonable dispute. *See* Del. R. Evid. 201(b)(2); *see also, e.g.*, *In re Gen. Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 169 (Del. 2006).

home price indices tell a similar story.[99] This boom in house prices, and the ease with which residents could sell their homes, was good for the economics of the Projects: most residents had to sell their houses to be able to move into the Projects, and as house prices increased, more residents were able to move in.[100] The increase in the appraised values to 2006 was thus linked, at least in part, to Florida's real estate boom. This boom came at a bad time for CalPERS: under the LLC Agreement, it was required to pay SHP an Incentive Distribution based on the appraised value of the Projects at the end of 2007.

Shortly before Integra completed its 2006 appraisals, CalPERS' Real Estate Unit retained a real estate consulting firm, Situs, to review CalPERS' senior housing investments.[101] The Situs team was led by Steve Ganns, who had no background in appraising senior housing.[102] Situs and CalPERS believed that it was necessary to review CalPERS' appraisal and valuation policies.[103] After the 2006 Integra appraisals were finalized, the focus of Situs' work became the Integra appraisals.[104] The record shows that the Real Estate Unit became concerned about the appraisals, and put pressure on the Performance Monitoring Unit, and in particular Enright, to review the appraisal policies.[105]

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[99] *See State Quarterly Purchase Only House Price Index*, Fed. Housing Fin. Agency (Dec. 2012), http://www.fhfa.gov/webfiles/24978/4q12hpistspo.xls (nonseasonally adjusted home sales in Florida peaked in the third quarter of 2006); *Metropolitan Statistical Area House Price Index Data*, Freddie Mac (Dec. 2012), http://www.freddiemac.com/finance/fmhpi/current/excel/msas_new.xls (house prices in the Tampa metropolitan area peaked in June 2006).
[100] *E.g.*, Tr. 120:21-121:14 (Anderson – Cross); 351:16-20 (Maksimow – Cross).
[101] *See* JX 457 (Situs engagement letter (Oct. 31, 2006)).
[102] Tr. 888:7-9 (Ganns – Cross).
[103] JX 501 (memo from Steve Ganns to Dan Enright (Dec. 6, 2006)).
[104] JX 529 (email from Jennifer Bean, Situs, to Dan Enright (Mar. 1, 2007)).
[105] *Id.*

Situs issued a report in July 2007 criticizing Integra's 2005 and 2006 appraisals.[106] Situs claimed that "[r]eliance on these values estimates in the Integra appraisals would significantly overstate the incentive fees due to SHP and have already been used to support the payment of Asset Management Fees to SHP."[107] CalPERS had only paid Asset Management Fees for the life of the joint venture in February 2007.[108] Situs criticized, in particular, the methodology of valuing the living facilities and health care facilities separately; the inclusion of the residents' interest in the fee simple value of the Projects; the assumptions about occupancy that Integra had used; and Integra's historical and forward-looking financial data.[109] CalPERS had Situs pass these criticisms on directly to Integra, which rejected them.[110] In his deposition and under cross-examination, Situs's Ganns admitted that he "didn't have the background" to disagree with Integra's decision to include the leasehold value in the appraised value of the Projects, but objected that it "seemed counterintuitive."[111]

Situs opined that the Projects were worth no more than the Fund had paid for them in 2003 and 2004, and recommended that CalPERS terminate its relationship with SHP.[112] CalPERS then forwarded the report to its outside counsel, Fred Minnes, of the Pillsbury firm.[113] Minnes replied that he would assist in formulating a strategy to help

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[106] JX 1474 (Situs report (July 2007)).
[107] *Id.* at 6.
[108] *See* JX 524 (email from SHP to CalPERS (Feb. 2, 2007)).
[109] JX 1474, at 6.
[110] Tr. 885:15-886:13 (Ganns – Cross).
[111] *Id.* 888:3-7; Ganns Dep. 73:7-13.
[112] JX 1474, at 6-7; JX 560 (email from Steve Ganns to Al Grijalva (July 25, 2007)).
[113] JX 557 (email from Al Grijalva to Fred Minnes (July 24, 2007)).

CalPERS exit its relationship with SHP.[114] Minnes observed, that if CalPERS was going to try to revise the Integra appraisals, it would need to involve SHP in the process, just as SHP had been involved in producing and commenting on all the previous appraisals:

> I recommend that, at some point, the manager be given an opportunity to respond to some of the significant findings and conclusions in the Summary Report because it will tend to protect CalPERS if liability claims against CalPERS are asserted by the manager in the future. . . .
>
> In particular, however, the manager will need to be included in some way in the correction of the appraisal methodology and data. The manager will, of course, argue that CalPERS accepted (at least tacitly) the 2005 and 2006 values and claim that CalPERS is just trying to manipulate the 2007 value to reduce the "Incentive Distribution" earned by the manager.[115]

Minnes's words were prescient.

H. CalPERS Orders Appraisals From A New Firm In 2007, And Tries To Ensure A Lower Valuation

CalPERS was aware that the 2007 appraisals were even more important than the valuations between 2003 and 2006, because the 2007 appraisals would affect the Incentive Distribution as well as set the Asset Management Fees. In the Performance Monitoring Unit, Enright was embarrassed by the Situs report, which had criticized the quality of the appraisals, and apologized to Ted Eliopoulos, who headed CalPERS' Real Estate Unit.[116] Therefore, CalPERS took pains to ensure that the 2007 appraisals would produce what it viewed as more accurate—*i.e.*, lower—values. The Florida housing

[114] JX 579 (letter from Fred Minnes to Al Grijalva (Aug. 2, 2007)).
[115] *Id.* at 2.
[116] JX 576 (email from Dan Enright to Ted Eliopoulos (Sept. 19, 2007)).

market had declined throughout 2007, such that, by the end of 2007, it was at the same level as it had been about July 2005.[117]

CalPERS engaged Duff & Phelps, another firm from its "spring-fed pool" of favored appraisers, to do the 2007 appraisals.[118] The Duff & Phelps team was led by Ross Prindle. CalPERS was concerned that SHP would somehow improperly influence the appraisal process by giving Duff & Phelps inaccurate or misleading information.[119] Therefore, Enright instructed Duff & Phelps not to rely on anything that SHP gave it.[120] Enright, under pressure from other members of staff in CalPERS, told Prindle that he feared "repercussions" if Duff & Phelps didn't carry out the appraisals independently.[121]

Duff & Phelps performed the appraisals of the market value of the Fund's Projects in accordance with their normal procedures, which were designed to ensure that the appraisals were unbiased.[122] The value Duff & Phelps arrived at—and which is the issue that the parties have litigated most vigorously—was $413 million.[123] This figure was

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[117] *S&P/Case-Shiller Not-Seasonally Adjusted Home Price Index*, Standard & Poor's (Jan. 2013), http://www.standardandpoors.com/indices/articles/en/us/?articleType=XLS&assetID=1221192472066.

[118] JX 585 (letter from Dan Enright to Ross Prindle (Oct. 15, 2007)).

[119] Enright Tr. 393:6-394:17.

[120] JX 587 (voicemail from Dan Enright to Ross Prindle (Oct. 19, 2007)) ("I understand from Al Grijalva upstairs that Craig [Anderson] has been very inquisitive as to who is going to be doing the assignment; has a lot of concerns. And I just want to make sure that you're aware that we really don't want his involvement in this appraisal.").

[121] *Id.*

[122] Prindle Dep. 39:14-22 (Q: "But you don't have any information that it wasn't a fully independent process, right? Do you have any information that despite Dan Enright's saying, I want you guys to be independent and do our own due diligence, that that didn't happen?" A. "As I understand it, we did the due diligence on the information that was provided . . . .").

[123] JX 621 (Regency Oaks appraisal (Dec. 15, 2007)); JX 622 (South Port Square appraisal (Dec. 15, 2007)); JX 623 (Lake Port Square appraisal (Dec. 15, 2007)); JX 624 (Sylvan Health

over $100 million lower than the value Integra had appraised the Projects at a year before, at the end of 2006. Nevertheless, Situs believed that CalPERS should not accept them without discussing them with Duff & Phelps and SHP.[124] Pottle agreed that CalPERS should "dispute" them.[125] Situs and the CalPERS Real Estate Unit, of course, were more concerned about the Incentive Distribution payable under the appraisals than the appraisals in and of themselves.[126] Under these appraisals, the Incentive Distribution payout was likely to be over $50 million.

On January 10, 2008, Minnes wrote to Al Grijalva in the Real Estate Unit to discuss how CalPERS could object to the appraisals.[127] Minnes pointed out that CalPERS was in a bind. Under the LLC Agreement, the Projects had to be valued at their Fair Market Value, which was, for each Project, "the value of such Project determined pursuant to CalPERS' Statement of Equity Real Estate and Valuation Property."[128] This Statement is attached to, and incorporated in, the LLC Agreement as Exhibit Q. This Exhibit provided an "Appraisal Arbitration Process" that either CalPERS or the Investment Manager could initiate, if they disagreed with the appraised value.[129] But, as Minnes pointed out, this arbitration process could only be triggered "*at the end of a*

Systems appraisal (Dec. 15, 2007)); JX 625 (Lake Harris Health Properties appraisal (Dec. 15, 2007)); JX 626 (Harbour Health Properties appraisal (Dec. 15, 2007)).
[124] JX 633 (email from Steve Ganns to Katherine Avery (Dec. 26, 2007)).
[125] Tr. 532:10-16 (Pottle).
[126] JX 645 (email from Steve Ganns to members of CalPERS Real Estate Unit (Jan. 8, 2008)) ("We can go into a very detailed analysis [of the Duff & Phelps appraisals] if necessary . . . . However, I believe we can go over the high points which are relevant [vis-à-vis] the incentive fees, etc.").
[127] JX 648 (letter from Fred Minnes to Al Grijalva (Jan. 10, 2008)).
[128] LLC Agreement §§ 1.1, 9.14.
[129] *Id.* Ex. Q § II.B.

contract period," which, in the case of the relationship between SHP and CalPERS, was to run until 2036.[130] The LLC Agreement provided for the payment of an Incentive Distribution based on a single appraisal, which was to be conducted by an appraiser selected by CalPERS, and in accordance with policies laid down by CalPERS' form contract.[131] Nothing in the LLC Agreement provided for any review of CalPERS' appraiser's determination. Minnes acknowledged this: he wrote to CalPERS that "*there is no procedure in the Limited Liability Company Agreement that gives CalPERS the right to reject an appraisal*."[132] Minnes suggested that the end of a "calculation period" could be treated in the same way as the end of a "contract period," and thus the Appraisal Arbitration Process could be made to apply, but acknowledged that this was legally dubious.[133]

Minnes drafted for CalPERS a letter for the Real Estate Unit to send to SHP stating simply that "CalPERS objects to the appraisals and does not accept the market values in them."[134] Minnes acknowledged that this "reservation of rights" was "necessarily general and somewhat vague," but said it was "the best CalPERS can do."[135] When a member of CalPERS' legal staff suggested that there should be at least some basis for the objection, Minnes, in a coy way that was telling, replied, "I would let SHP

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[130] JX 648.
[131] *See* LLC Agreement Ex. Q.
[132] JX 648 (emphasis added).
[133] *Id.*
[134] *Id.*
[135] *Id.*

figure out by itself on what basis under the Limited Liability Company Agreement CalPERS has the right to object."[136] Pottle sent the letter the following day.[137]

Having filed this placeholder objection, CalPERS did not take any further steps to dispute the appraisals.[138] Anderson testified at trial that Pottle called him after sending the letter to tell him that it was "[n]o big deal" and just "standard procedure."[139] CalPERS did not even inform Duff & Phelps that it believed that the appraised values were too high. Most important, at the end of January, Enright in the Performance Monitoring Unit specifically authorized the appraisals to "go final."[140]

I. CalPERS Tries To Avoid Paying The Incentive Distribution Under The LLC Agreement, And SHP Withdraws From The Fund

CalPERS' Investment Committee discussed the question of what to do with SHP at its February 2008 meeting.[141] Ted Eliopoulos told the committee that there were three options: (i) do nothing, (ii) restructure the relationship, or (iii) remove SHP.[142] Option one was not attractive, because the Real Estate Unit and Situs agreed that CalPERS should no longer have a "long-term strategic relationship" with SHP.[143] Option three was also unattractive, because of the terms of the LLC Agreement. Eliopoulos admitted that there was no ground to remove SHP as the manager with cause under the LLC Agreement, and if CalPERS sought to remove SHP without cause, SHP could elect to be

[136] JX 649 (email from Fred Minnes to Javier Plasencia (Jan. 10, 2008)).
[137] JX 653 (letter from Randy Pottle to Craig Anderson (Jan. 11, 2008)).
[138] *E.g.*, Tr. 542:2-12 (Pottle).
[139] Tr. 58:18 (Anderson).
[140] Tr. 413:10-13 (Enright); JX 661 (email from Dan Enright to Ross Prindle (Jan. 24 2008)).
[141] JX 688 (minutes of Investment Committee closed session (Feb. 19, 2008)).
[142] *Id.* at 56.
[143] *Id.* at 55.

bought out at the value of the Duff & Phelps appraisals.[144] Eliopoulos noted that the Florida real estate market was weakening, and the December 2007 appraised value was probably higher than what a buyer would pay for the Projects if they were placed on the market at that time.[145] Therefore, Eliopoulos said, the second option was best—restructuring the relationship with SHP so that, in a few years' time, SHP would be obliged to sell the Projects, and SHP would be paid a cut of the price they fetched, rather than a possibly above-market appraised value.[146]

This was a reversal of the position that CalPERS had taken when it had entered the relationship, when CalPERS believed that it was best if SHP *not* be encouraged to sell the Projects in order to realize its returns.[147] At no time did Eliopoulos suggest that anything was wrong with the appraisals other than the fact that they generated too high an Incentive Distribution for SHP. Eliopoulos did not suggest that there was any major error in the methodology, such as Situs suggested when challenging the inclusion of the leasehold interest in the Fair Market Value.[148] And CalPERS' Real Estate Unit knew that there was a benefit to having the Projects appraised at a high value: it could report these values when calculating the value of its portfolio, which it presented in its public documents. In fact, in 2008 and 2009, CalPERS, all while haggling with SHP over the "correct" appraisal of the Projects and even after the initiation of this lawsuit, publicly

[144] *Id.* at 57-58.
[145] *Id.*
[146] *Id.* at 59.
[147] JX 25 (letter from Craig Anderson to Brian Bailey, CalPERS (Mar. 6, 2001)).
[148] *See* JX 650 (memorandum from Situs to CalPERS Real Estate Unit (Jan. 10, 2008)).

reported to the state of California, and the pension beneficiaries for whom it operates, the value of the Projects based on the Duff & Phelps appraisals no fewer than *six* times.[149]

Situs began renegotiating with SHP the terms of SHP's relationship on behalf of CalPERS. But, Situs and CalPERS had little leverage. The component of the Incentive Distribution that CalPERS was contractually obligated to pay SHP on account of the Duff & Phelps appraisals was worth over $40 million. As Situs acknowledged, SHP was doing a solid job at managing the Projects.[150] And, removing SHP would create other potential problems for CalPERS: for example, if CalPERS took over control of the Fund, it might find itself in breach of Florida law because it had not been approved by the state regulator to be the controller of the Projects, and CalPERS' withdrawal might trigger a technical default on the Projects' mortgage loan.[151] Therefore, CalPERS was in a position of weakness. CalPERS believed that it might be able to "encourage [SHP] to accept an amendment" to the LLC Agreement if it exercised its right under the LLC Agreement to require SHP to sell the properties, but CalPERS was also aware that it was a bad time to sell.[152] Furthermore, a sale would have no direct impact on the payment of the Incentive Distribution, which was already due. On CalPERS' behalf, Situs commissioned a broker's opinion of value from another firm, Eastdil Secured, to

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[149] JX 1561-66 (CalPERS' Real Estate Quarterly Performance reports (May 2008 – Aug. 2009)).
[150] JX 753, at 6 (memo from Steve Ganns to CalPERS (June 4, 2008)) ("[A]ny change to the positive [in the manager] would not necessarily be dramatic or remarkable.").
[151] *Id.* Ex. 1, at 2.
[152] JX 1482 (letter from Fred Minnes to Al Grijalva (Jan. 18, 2008)).

determine how much a buyer might pay for the Projects, but CalPERS did not take any further steps to force a liquidation of the properties.[153]

SHP resisted CalPERS' suggestion that it delay paying the Incentive Distribution that was due on account of the 2007 calculation date. SHP stated that, for tax reasons, it wanted to receive the Incentive Distribution in 2008. SHP also rejected CalPERS' other suggestions for restructuring the relationship. SHP suggested two options to terminate the relationship: first, that SHP withdraw from the Fund, or second, that SHP buy out CalPERS' interest.[154] The first of these options was undesirable to CalPERS, because it would make CalPERS liable to pay the Incentive Distribution. The second option was no better, because SHP insisted that the Incentive Distribution that CalPERS was already obligated to pay be credited against the purchase price. Thus, if CalPERS attached a low valuation to the Projects (below $163 million), it would have to pay SHP to take them off its hands.[155]

All of the potential scenarios, therefore, involved the outcome that CalPERS wanted to avoid—paying an Incentive Distribution to SHP of over $50 million. SHP also informed CalPERS that it was prepared to withdraw from the relationship because that was the only way to make CalPERS pay the Incentive Distribution on time, and to obtain its desired tax treatment.[156] As negotiations got nowhere, SHP decided to withdraw, and

[153] JX 747 (Eastdil opinion of value (May 2008)).
[154] JX 753 Ex. 1, at 1-2 (memo from Steve Ganns to CalPERS (June 4, 2008)); Tr. 59:2-18 (Anderson).
[155] Tr. 157:16-158:2 (Anderson – Cross).
[156] JX 753 Ex. 1, at 2; Tr. 157:8-10 (Anderson – Cross).

sent CalPERS its formal notice of withdrawal on June 12, 2008.[157] The effective date of this withdrawal, under the LLC Agreement, was 180 days later, on December 8, 2008.[158]

J. <u>As The Housing Market Deteriorates, CalPERS Continues To Try To Minimize The Incentive Distribution</u>

CalPERS did not give up on trying to force SHP to renegotiate its contract. In June, CalPERS decided to follow through on its plan of requiring, or purporting to require, SHP to sell the Projects.[159] CalPERS instructed SHP to arrange for them to be sold by SHP's departure in mid-December, a mere half-year away. Anderson discussed selling the Projects with Ganns and informed him that selling them in that timeframe would be difficult, if not impossible, because of the need to get approval from the relevant Florida regulatory agencies.[160] Anderson also reminded Eliopoulos of what he already knew to be true as of July 2008—namely, that debt financing had dried up, senior housing companies were no longer looking to make acquisitions, and the timing was accordingly very bad for a rushed sale of the Projects.[161]

For readers not already painfully aware of key financial events in 2008, by March of that year the credit markets had already been rocked by Bear Stearns's failure, which resulted in no small part from excessive speculation on real estate values. As of mid-2008, the real estate outlook was far bleaker than it was when Duff & Phelps completed the appraisal for the payment of the Incentive Distribution. In September 2008, of

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157 JX 755 (letter from Craig Anderson to Ted Eliopoulos (June 12, 2008)).
158 *Id.*; LLC Agreement § 5.1(a).
159 JX 766 (letter from Ted Eliopoulos to Craig Anderson (June 23, 2008)).
160 JX 780 (letter from Craig Anderson to Ted Eliopoulos (July 11, 2008)).
161 *Id*.

course, Lehman Brothers collapsed, resulting in an emergency bail-out (through the Troubled Asset Relief Program and other sources) and multi-year financial subsidy (through the near-zero percent Federal Reserve discount window) of Wall Street by American taxpayers. The larger world financial system was propped up by the taxpayers of other nations, with U.S. help. But despite the lack of financial sense in selling the Projects, CalPERS pressed on with trying to force a sale. At CalPERS' request, SHP put together an offering memorandum for the properties and hired a broker.[162] But, because of the complexities of the properties, the offering memorandum was only completed in November.[163] CalPERS always knew that a sale would be unlikely, and, starting in June 2008, had begun to plan for another company, AEW, to take over the Projects.[164] AEW was the other senior housing partner that CalPERS had selected when it first moved into senior housing in 2000.[165] CalPERS eventually abandoned its half-hearted efforts to have SHP sell the Projects in November 2008.[166]

Asking SHP to sell the Projects was not CalPERS' only bargaining tool. In July 2008, Situs advised CalPERS to ask Duff & Phelps to "restate" its appraisal of the market value of the Projects as of the end of 2007, in which it valued the Projects at $413 million.[167] Ross Prindle at Duff & Phelps discussed the 2007 appraisals with Ganns, and told Enright that Duff & Phelps would not be revising the appraisals unless it "received

[162] JX 782 (letter from Randy Pottle to Craig Anderson (July 16, 2008)); JX 1545 (SHP offering memorandum).
[163] JX 946 (email from Craig Anderson to Randy Pottle (Oct. 23, 2008)).
[164] JX 758 (AEW internal email (June 16, 2008)).
[165] *See* JX 17 (memo from CalPERS Real Estate Investment Office to Investment Committee (Oct. 16, 2000)).
[166] *See* JX 1261, at 45 (Resps. to Pls.' First Set of Interrogs. ¶ 68).
[167] *See* JX 792 (email from Al Grijalva to Fred Minnes (July 31, 2008)).

bad information from SHP or inaccurate facts."[168] Prindle also noted that Ganns had "not articulated what his issues are with the appraisal."[169] Regardless, CalPERS insisted on providing Duff & Phelps with information it alleged that it had "failed to take into account in preparing the 12/31/07 appraisal."[170]

I find, as a factual matter, that Duff & Phelps did not fail to take into account any of the information that CalPERS accused it of neglecting. First, this information included details of SHP's "actual revenues and expenses for 2007 *and 2008*" meaning that CalPERS wished Duff & Phelps to revise the 2007 appraisals *based on information that did not exist as of the appraisal date,* which was December 31, 2007.[171] And, there is no evidence that Duff & Phelps did not have accurate details of revenues and expenses for those periods for which financial statements were available as of the date of their appraisal work, or that Duff & Phelps failed to receive any information from SHP that Duff & Phelps deemed relevant to its work. Second, CalPERS wanted Duff & Phelps to take into account Eastdil's broker's opinion of value, which, in addition to being of questionable reliability,[172] also did not exist as of the end of 2007, the relevant appraisal date.[173] Third, CalPERS claimed that Duff & Phelps had overlooked the Fund's "home to home" program, whereby the Fund would purchase homes from future residents who

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[168] JX 807 (email from Ross Prindle to Dan Enright (Aug. 7, 2008)).
[169] *Id.*
[170] JX 819 (email from Fred Minnes to Randy Pottle (Aug. 20, 2008)).
[171] *Id.* (emphasis added).
[172] *See* Dennis Dep. 87:4-88:23.
[173] JX 819; *see* JX 747 (Eastdil opinion of value (May 2008)).

could not sell their homes on the open market.[174] But, at trial, Enright testified that Duff & Phelps had been provided with information about the homebuying program in advance of performing its appraisals.[175] Finally, CalPERS had chosen Duff & Phelps in the first instance, and had admonished Duff & Phelps not to trust SHP and instead to use its own judgment. Thus the notion that veteran spring-fed pool swimmer Duff & Phelps deferred to SHP in any way is implausible.

Minnes realized the impropriety of asking Duff & Phelps outright to revise its appraisals, which CalPERS had signed off on several months before. Instead, he wanted to give Duff & Phelps an "invitation" to restate the appraisals, and he hoped Duff & Phelps would take the "initiative" to do so.[176] CalPERS conducted its discussions with Duff & Phelps in private, and Minnes stressed to Grijalva and Pottle that "[w]e need to guard our strategy so nothing is revealed to SHP."[177] But, SHP discovered the revision process when Enright forwarded to Anderson an email from Duff & Phelps in which Duff & Phelps requested further documents.[178] Anderson was confused, because he was unaware of any involvement that Duff & Phelps still had in appraising the Projects; the Projects had to be appraised as of October 2008, because SHP was withdrawing from the Fund, but CalPERS had engaged a different firm, Cushman & Wakefield, to perform

[174] JX 819.
[175] Tr. 401:24-402:12 (Enright).
[176] JX 819; JX 826 (email from Fred Minnes to Dan Enright (Aug. 22, 2008)).
[177] JX 834 (email from Dan Enright to Ross Prindle (Aug. 27, 2008)); JX 869 (email from Fred Minnes to Al Grijalva (Sept. 5, 2008)).
[178] JX 854 (email from Dan Enright to Craig Anderson (Sept. 2, 2008)).

those appraisals.[179] Minnes chastised Enright for forwarding the email, because CalPERS "want[ed] to avoid arousing suspicion."[180] Enright then consulted Minnes on how he should respond to Anderson. Enright composed a draft response, which mischaracterized the nature of Duff & Phelps's involvement, and after Minnes had approved it as "excellent," sent it to Anderson.[181]

About the end of August, Duff & Phelps agreed to look at the supposedly new information that CalPERS provided, despite its initial reservations.[182] But, it was worried that a restatement might expose it to liability from SHP. Therefore, it asked CalPERS to send SHP a release and hold harmless letter that would protect Duff & Phelps from any liability to SHP.[183] Minnes recommended that CalPERS refuse to sign it, because "we need to be careful about injecting CalPERS into it."[184] Duff & Phelps then prepared a formal engagement letter to send to CalPERS, which made clear that CalPERS had provided Duff & Phelps with the "new" information and was seeking the restatement.[185] CalPERS rejected this draft and rewrote it to imply that Duff & Phelps had been provided with new information by a party other than CalPERS.[186]

Minnes pushed Duff & Phelps to complete the restatements by the time that SHP withdrew from the Fund, in case "all of the hard work CalPERS [had] put in" should go

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[179] *Id.* (email from Craig Anderson to Dan Enright (Sept. 2, 2008)).
[180] *Id.* (email from Fred Minnes to Dan Enright (Sept. 2, 2008)).
[181] JX 855 (email from Fred Minnes to Dan Enright (Sept. 2, 2008)); JX 856 (email from Dan Enright to Craig Anderson (Sept. 2, 2008)).
[182] *See* Prindle Dep. 114:9-117:14.
[183] JX 1594 (email from Dan Enright to Fred Minnes (Sept. 25, 2008)).
[184] JX 906 (email from Fred Minnes to Dan Enright (Sept. 30, 2008)).
[185] JX 923 (draft of letter from Ross Prindle to Dan Enright (Oct. 9, 2008)).
[186] JX 924 (letter from Ross Prindle to Dan Enright (Oct. 9, 2008)); Baldwin Dep. 122:24-123:2.

to waste.[187] Duff & Phelps produced the draft "Restated Appraisals" on November 19, 2008. The new aggregate market value of the leased fee interest was $286 million—a reduction of $60 million from the previous value.[188] CalPERS and Duff & Phelps then had a phone call to discuss these values.[189] After this call, Duff & Phelps reduced the leased fee value to $249 million, a reduction of another $37 million.[190] At trial, an expert for SHP, Rajiv Gokhale, testified convincingly that the two reasons that Duff & Phelps gave for restating the appraisals—that SHP had given Duff & Phelps inaccurate financial information, and that Duff & Phelps was not aware of SHP's homebuying program—could not justify this huge reduction in value.[191]

CalPERS instructed Duff & Phelps to sit on the Restated Appraisals for a week, and only authorized Duff & Phelps to release them to SHP on December 3, five days before the effective date of SHP's withdrawal from the Fund.[192] Minnes wanted them to be released just after another round of appraisals, from October 2008, was released, presumably to lend the values in them more credibility.[193]

Duff & Phelps declared that the Restated Appraisals "superseded" the Original Appraisals, and that the Original Appraisals were "null and void."[194] As a result of this,

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[187] JX 994 (email from Fred Minnes to Dan Enright (Nov. 11, 2008)).
[188] JX 1020 (email from David Baldwin to Dan Enright (Nov. 19, 2008)).
[189] JX 1036 (conference call invitation (Nov. 24, 2008)).
[190] JX 1038 (email from David Baldwin to Randy Pottle (Nov. 25, 2008)).
[191] Tr. 636:20-665:18 (Gokhale).
[192] JX 1080 (restated Sylvan Health appraisal (Dec. 3, 2008)); JX 1081 (restated Lake Harris Health appraisal (Dec. 3, 2008)); JX 1082 (restated Harbour Health appraisal (Dec. 3, 2008)); JX 1083 (restated South Port Square appraisal (Dec. 3, 2008)); JX 1084 (restated Regency Oaks appraisal (Dec. 3, 2008)); JX 1085 (restated Lake Port Square appraisal (Dec. 3, 2008)).
[193] *E.g.*, JX 1064 (email from Fred Minnes to Dan Enright (Dec. 1, 2008)).
[194] *E.g.*, JX 1080, at 1.

KPMG withdrew its audit opinion for the Fund's 2007 financial statements, which was based on the Original Appraisals.[195]

K. CalPERS Hires New Firms To Appraise The Properties As Of October 2008

Under the LLC Agreement, CalPERS needed to have the Projects appraised as of October 9, 2008, so that it could purchase SHP's interest in the Fund.[196] CalPERS selected Cushman & Wakefield, which, like Duff & Phelps, was part of the "spring-fed pool" and with which it had a long-term relationship.[197] As with Duff & Phelps, CalPERS put pressure on Cushman & Wakefield to deliver the results it wanted. The Cushman & Wakefield team was informed that it was their "single most important assignment," and Stan Dennis, the Cushman & Wakefield managing director who ran the project, was told that CalPERS was "frustrated" with SHP and that there might be litigation.[198]

Cushman & Wakefield completed its draft appraisals by the end of November. Unlike the previous appraisals, CalPERS instructed Cushman & Wakefield to produce three, not six, appraisals.[199] And, in another break with past practice, CalPERS did not allow Cushman & Wakefield to circulate them immediately to SHP: Minnes warned that "[r]evising the [appraisal] value after the draft has been issued will be very difficult."[200] CalPERS' main concern with the draft Cushman & Wakefield appraisals was the

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[195] JX 1215 (letter from KPMG to CalPERS and SHP (Apr. 15, 2009)).
[196] LLC Agreement § 5.1(a).
[197] Dennis Dep. 61:16-63:17.
[198] JX 853 (email from Stan Dennis to Dan Enright (Sept. 2, 2008)); Dennis Dep. 48:24-49:1.
[199] JX 792 (email from Al Grijalva to Fred Minnes (July 30, 2008)).
[200] JX 1034 (email from Fred Minnes to Randy Pottle (Nov. 24, 2008)).

discount rate. The November 24 drafts that Cushman & Wakefield sent to CalPERS used an 11.5% discount rate, but, after Pottle spoke with Dennis, Cushman & Wakefield increased the discount rate to 13%.[201] This change wiped over $18 million off the value of the Projects, but the reasoning that Cushman & Wakefield used to support the 13% figure was identical to that it used to support the 11.5% figure.[202] The Cushman & Wakefield appraiser who was responsible for making the change, Neil Salzgeber, did not recall at his deposition why "specifically" he made a change that cut almost 10% off the appraised value of the Projects, and instead said that Cushman & Wakefield had repeated the same kind of analysis that it had done to arrive at the 11.5% figure.[203] Stan Dennis, the Cushman & Wakefield managing director, testified that he attempted to explain to Pottle that the 11.5% figure was "appropriate and reasonable and supportable," but that Pottle instructed Cushman & Wakefield to go back to the market and find information supporting a "much higher discount rate."[204] Despite the increase to 13%, Pottle showed "great angst and agitation" over the discount rate, because he believed it should still be "much higher."[205] Pottle, for his part, claimed in his deposition that he did not remember anything about discussions with Cushman & Wakefield over the discount rate.[206]

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[201] *See, e.g.*, JX 1046, at 158-59 (Lake Port Square & Lake Harris Health Center appraisal report (Nov. 25, 2008)); JX 1072, at 158-59 (final Lake Port Square & Lake Harris Health Center appraisal report (Dec. 2, 2008)); Salzgeber Dep. 218:20-25; Dennis Dep. 192:22-193:22.
[202] JX 1046; JX 1072.
[203] Salzgeber Dep. 222:10-18.
[204] Dennis Dep. 192:13-193:10.
[205] *Id.* at 193:20-21, 196:22.
[206] Pottle Dep. 342:15-344:8.

Cushman & Wakefield appraised the market value of the leased fee interest of the Projects at $176 million.[207] But, CalPERS requested Cushman & Wakefield to issue the reports after taking into account a "hypothetical condition," under which $34 million, representing the value of supposed shortfalls in the Fund's cash flows over the previous three years, was deducted from the Projects' value.[208] CalPERS claimed that it did not know about the origins of this cash shortfall, even though it stemmed from SHP's use of the cash management system, which SHP used, with CalPERS' permission, to fund the Projects' ongoing needs.[209] Cushman & Wakefield thus deducted $34 million from the value of the Projects, arriving at a value of $142 million.[210]

SHP objected to the Cushman & Wakefield appraisals.[211] CalPERS then invoked the Appraisal Arbitration Process of the LLC Agreement, which provided a procedure to resolve valuation disputes "at the termination of the contract period."[212] Under the Appraisal Arbitration Process, either party could obtain another appraisal "at its own expense" from "an appraiser [on] the System's approved list."[213] CalPERS selected CB Richard Ellis ("CBRE"). CBRE appraised the market value of the Projects at $142 million.[214] After lengthy discussions with Pottle, CBRE reduced the value of its

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[207] JX 1122 (Regency Oaks and Sylvan Health Center appraisal report); JX 1123 (South Port Square and Harbour Health Center appraisal report); JX 1125 (Lake Port Square & Lake Harris Health Center appraisal report).
[208] JX 1101 (email from Dan Enright to Stan Dennis (Dec. 4, 2008)).
[209] *Id.*
[210] JX 1122; JX 1123; JX 1125.
[211] JX 1137 (letter from Craig Anderson to Randy Pottle (Dec. 7, 2008)).
[212] LLC Agreement Ex. Q § II.B.
[213] *Id.*
[214] JX 1219 (Harbour Health Center (May 22, 2009)); JX 1220 (Lake Harris Health Center (May 26, 2009)); JX 1221 (Sylvan Health Center (May 26, 2009)); JX 1225 (Regency Oaks (June 12,

appraisals to $135 million, by increasing the discount rates and capitalization rates.[215] Don Spradlin, a managing director at CBRE, accused Pottle of "meddling" in the valuation process, with "no data to support his arguments" and "ignor[ing] the fact that our [date of valuation] is 10/08, now 11 months ago."[216] Despite CBRE's reduction in value, Pottle pushed for further value reductions,[217] and continued to do so until CBRE got fed up with CalPERS and demanded that the appraisals go final so that it could be paid.[218] Eventually, the original CBRE appraisals were sent to SHP for its review.[219] Anderson rejected the appraisals, claiming that CalPERS had no right to invoke the Appraisal Arbitration Process.[220] Anderson also claimed that the CBRE appraisals were "fundamentally flawed" and "fail[ed] to comply with the requirements of the LLC Agreement and past appraisal protocols implemented by CalPERS."[221]

Under the terms of the Appraisal Arbitration Agreement, if the second appraisal was within 5% of the first appraisal, the two appraisals would be averaged.[222] CBRE's market value of $142 million was more than 5% from Cushman & Wakefield's market value of $176 million, and CalPERS ordered a new set of appraisals from a third firm, Colliers. These appraisals were delivered in August 2010, almost two years after the

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2009)); JX 1226 (Lake Port Square (June 12, 2009)); JX 1227 (South Port Square (June 12, 2009)).

[215] JX 1246 (email from Don Spradlin, CBRE, to Dan Enright (Aug. 24, 2009)).

[216] JX 872 (CBRE internal email (Sept. 9, 2009)).

[217] JX 1245 (email from Randy Pottle to Dan Enright (Aug. 24, 2009)).

[218] JX 1250 (email from Don Spradlin to Dan Enright (Oct. 5, 2009)).

[219] JX 1255 (email chain between Dan Enright and Craig Anderson (Oct.-Nov. 2009)).

[220] *Id.*

[221] *Id.*

[222] LLC Agreement Ex. Q § II.B.

valuation date. Colliers appraised the market value of the Projects at $149 million.[223] SHP provided comments on these appraisals, and also rejected them.[224] CalPERS likewise rejected them, alleging that they were not compliant with the Uniform Standards of Professional Appraisal Practice ("USPAP").[225]

III. The Parties' Contentions

SHP asserts various breaches of the LLC Agreement and the Management Agreements. CalPERS denies these breaches, in whole or in part. SHP's claims relate to:

1. *The Incentive Distribution*. SHP claims that CalPERS owes it approximately $52 million as the Incentive Distribution, which is payable under Exhibit H of the LLC Agreement. This Incentive Distribution is based on the Fund's internal rate of return, which is driven by two inputs: (1) the appraised value of the Projects as of December 31, 2007; and (2) the cash returned to CalPERS in the form of "Distributions" over the life of the Fund.[226] The Incentive Distribution that SHP is entitled to is calculated by comparing the Fund's internal rate of return to hurdle rates set out in the LLC Agreement. There are three different sets of hurdle rates, with the lowest (and hence easiest to achieve for SHP)

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[223] JX 1287 (Regency Oaks and Sylvan Health Center (Aug. 2, 2010)); JX 1290 (South Port Square and Harbour Health Center (Aug. 16, 2010)); JX 1291 (Lake Port Square and Lake Harris Health Center (Aug. 16, 2010)).
[224] JX 1308 (letter from Matt Fischer, Potter Anderson, to Sharon O'Grady, Pillsbury (May 31, 2011)).
[225] JX 1314 (letter from Sharon O'Grady to Bob Steed, Colliers (Aug. 31, 2011)).
[226] LLC Agreement Ex. H § 4.

being those that are applied to Independent Living Projects, and the highest being those that are applied to CCRCs.[227]

As to the first input of the Incentive Distribution, the LLC Agreement provides that CalPERS shall obtain an "[a]n annual independent appraisal of market value" to determine the value of the Projects.[228] SHP seeks to have this court declare that the Original Duff & Phelps Appraisals are the only appraisals that may be used for the market value of the Projects as of the end of 2007. SHP also seeks a declaration that the Fund's returns of cash to CalPERS over the life of the Fund should be considered as Distributions in the calculation of the Incentive Distribution.

CalPERS disputes this $52 million claim. CalPERS' position as to the correct input for the appraised value of the Projects changed over the course of the trial, but CalPERS now wants this court to appraise the Projects for itself, as if this was an appraisal under 8 *Del. C.* § 262. CalPERS then argues that this court should accept as reliable the appraisals that were carried out by its litigation expert, Michael Boehm, in 2011 and which relied in part on 2011 data. CalPERS asks this court to disavow both the Original Duff & Phelps Appraisals and the Restated Duff & Phelps Appraisals. CalPERS also challenges SHP's accounting of Distributions back to CalPERS, and claims that SHP did not comply with the rules of CalPERS' cash management system. The dispute over SHP's accounting represents about $8 million of the $52 million dispute over the Incentive Distribution.

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[227] *Id.*

[228] *Id.* Ex. Q § 1; *see also* LLC Agreement § 1(defining "Fair Market Value" and referring to Exhibit Q for the process by which this Fair Market Value is to be determined).

The parties also dispute the correct hurdle rates to use. SHP claims that both the Independent Living and the CCRC hurdle rates should be used. CalPERS claims that only the CCRC hurdle rates, which are higher than the Independent Living hurdle rates, should be used. This dispute affects no more than $400,000 of the Incentive Distribution payout.

2. *The Membership Interests.* Under Section 5.1(a) of the LLC Agreement, CalPERS is required to purchase SHP's and SHC's Membership Interests when they withdraw from the Fund. SHP claims at least $1,000,000 for its Membership Interests, based on the Cushman & Wakefield appraisals. SHP also suggests that this court should increase this figure to $1,800,000 by reversing the increase in the discount rate that Cushman & Wakefield applied after Pottle discussed the draft appraisals with them. CalPERS, on the other hand, argues that the Fund had no equity value when SHP withdrew, and so no payment for SHP and SHC's Membership Interests is due.

The parties also dispute the date as of when the Membership Interests should be valued. SHP argues that they should be valued as of October 9, 2008. CalPERS claims that the Membership Interests should be valued in part as of October 9, 2008, and in part as of December 8, 2008.

3. *The Asset Management Fees*. Under Exhibit H of the LLC Agreement, SHP is entitled to quarterly Asset Management Fees based on the Fair Market Value of the Projects. SHP claims that it has not been paid Asset Management Fees of $500,000 for the period between October 1 and December 8, 2008. SHP claims that the Original Duff & Phelps Appraisals should be used as the basis for the calculation of the Fair Market

Value of the Projects. CalPERS argues that the Original Duff & Phelps Appraisals are inaccurate, and cannot be the basis of the Asset Management Fees calculation. CalPERS also argues that SHP has erroneously included the value of the residents' interest, or leasehold, in the Fair Market Value of the Projects. Finally, CalPERS argues that it overpaid SHP its Asset Management Fees between December 31, 2007, and October 1, 2008, and seeks to reclaim approximately $1,300,000.

4. *The Severance Compensation*. Under each Management Agreement that governed SHP's operation of the Projects, SHP's captive Project operator was entitled to Severance Compensation from the CalPERS-controlled Project owner if the Project owner "terminate[d] this Agreement without cause."[229] Section 3.02(D) also provides that "a change in the manager of the Fund (such that SHP is no longer the manager of the Fund) shall constitute a termination of this Agreement by Owner, without cause."[230]

Because SHP ceased to be the manager of the Fund in December 2008, SHP claims that it is owed (through its Project operators) $1,200,000 as Severance Compensation. CalPERS concedes that, under the plain language of the Management Agreements, SHP is entitled to Severance Compensation because there was a change in the manager of the Fund. But, CalPERS seeks reformation, arguing that the parties intended that SHP should be paid Severance Compensation under the Management Agreements only if CalPERS directed SHP to dismiss its captive Project operators, or if CalPERS dismissed SHP as the Fund manager without cause. CalPERS claims that it

[229] IL Management Agreements § 3.05; HC Management Agreements § 3.04.
[230] IL Management Agreements § 3.02(D); HC Management Agreements § 3.02(D).

would be unfair for SHP's captive operators to receive Severance Compensation simply because SHP chose to resign as the Fund manager.

In addition to these four main claims, SHP seeks attorneys' fees and pre-judgment interest. CalPERS, in its counterclaim, alleges that SHP breached its fiduciary duty to CalPERS and failed to submit financial statements that were approved by an auditor. CalPERS seeks to obtain the Fund's books and records, and has demanded that SHP make an accounting of all the Fund's financial activity.

IV. The Standard Of Review Of The Appraisals

To resolve these claims and counterclaims, a critical issue must be decided. What judicial standard of review is appropriate when one of the parties seeks to dispute the value determined by the contractually designated appraiser? To answer this question, I first describe what the appraisers were required to value under the terms of the LLC Agreement. I then describe SHP's arguments why I should leave these appraised values untouched, and CalPERS' arguments why I should modify them. I then explain why SHP is largely correct.

A. The Appraisers' Valuation Of The Projects Under The LLC Agreement

As explained, the provisions of the LLC Agreement governing the appraisal process were based on form contracts CalPERS uses with various investment managers. Those contracts give CalPERS important unilateral authority over the appraisal process used to determine important inputs to contractually defined terms. To wit, the Incentive Distribution, the Asset Management Fees, and the Membership Interests are all based on the Fair Market Value of the Projects. The LLC Agreement provided the terms under which CalPERS was to have the Fair Market Value of the Projects appraised, and the references to "Staff" are to the staff of CalPERS itself:

> An annual independent appraisal of market value shall be obtained for each investment in the core portfolio to assist Staff in measuring and verifying asset performance. Scheduling of appraisals within a given year shall be *at the discretion of Staff* and shall occur on a rolling four-quarter basis. *Staff*, in conjunction with the Real Estate Pension Consultant, *shall select appraisers* appropriate to perform valuations on the real estate investments.[231]

Section 1.1 of the LLC Agreement defines "Fair Market Value" as the value of a Project determined in an appraisal.[232] For a description of an appraisal, the definition refers to Exhibit Q of the Agreement, which provides that

> the appraisals are to provide a market value estimate of the System's specific interest in real estate assets. The market value should be based on the USPAP definition and, therefore should reflect the most probable price the System's interest would sell for given a reasonable exposure period and assuming a willing and knowledgeable buyer and seller.[233]

All the appraisers CalPERS selected were instructed to value the Fair Market Value of the Projects in accordance with the guidelines quoted above, and all of them did so.[234] Once the appraisers determined the Fair Market Values, the resulting contractual

[231] LLC Agreement Ex. Q § 1 (emphasis added).
[232] *Id.* § 1.1.
[233] *Id.* Ex. Q § II.A.
[234] *See, e.g.*, JX 123, at 1 (American Appraisal Associates valuation of Lake Port Square (Jan. 14, 2004)) ("market value"); JX 216, at 2 (Integra appraisal of Regency Oaks (Jan. 3, 2005)) ("market value of the fee simple interest"); JX 377, at 2 (Integra appraisal of Regency Oaks (Jan. 13, 2006)) ("market value of the fee simple interest"); JX 490, at 2 (Integra appraisal of South Port Square (Dec. 19, 2006)) ("market value of the fee simple interest"); JX 621, at 3 (Original Duff & Phelps Appraisal of Regency Oaks (Dec. 15, 2007)) ("market value of the fee simple interest"); JX 1083, at 7 (Restated Duff & Phelps Appraisal of South Port Square (Dec. 3, 2008)) ("market value of the fee simple interest"); JX 1122, at 4 (Cushman & Wakefield Regency Oaks/Sylvan Health Center appraisal (Dec. 5, 2008)) ("market value of the fee simple estate"); JX 1225, at 3 (CBRE Regency Oaks appraisal (June 12, 2009)) ("market value"); JX 1290, at 2

Fair Market Values were used in the relevant contractual formula to calculate the payout (if any) to SHP.[235] The appraisers were not responsible for calculating the payouts to SHP; their role was limited to determining the Projects' Fair Market Value. That is, the appraisers CalPERS selected determined one of the contractually defined inputs used for various purposes under the LLC Agreement, and CalPERS had the duty to use that input faithfully in accordance with the contractual formula and make a payout based on the arithmetic result the formula produced.

B. The Parties' Arguments On The Standard Of Review Of The Appraisals

The parties dispute whether these Fair Market Values should be binding on them. The parties' positions on this court's ability to alter the appraised Fair Market Values are not as clear as they might be, but I shall summarize them as best I can.

At post-trial argument, SHP seemed to claim that this court has no ability at all to review the appraisals for any reason.[236] SHP notes that the appraisal process is governed by the LLC Agreement, which, under its own terms, does not leave open any option for

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(Colliers South Port Square/Harbour Health Center appraisal (Aug. 16, 2010)) ("market value of the fee simple interest").

The appraisers did not use consistent terminology. For example, Cushman & Wakefield valued what I have referred to in this opinion as the leased fee interest, but referred to it as the "Market Value of the Fee Simple estate . . . as a going concern." *E.g.*, JX 1122, at 3. What Cushman & Wakefield meant by this was that it was valuing as much of the fee simple estate that the Fund had the right to sell. This is what Duff & Phelps referred to in their appraisals as the leased fee value. (The Fund was not able to sell the residents' interest, or the leasehold interest.) The appraisers were also not always clear in explaining their terminology. *E.g.*, Salzgeber Dep. 124:3-127:23; Tr. 1045:10-1051:23 (Boehm – Redirect). Nevertheless, it is plain that all the appraisers valued what the Projects could be sold for in the open market—that is, their Fair Market Value.

[235] For the Incentive Distribution and the Asset Management Fees, the payout was determined by a formula in Exhibit H of the LLC Agreement; for the Membership Interests, the payout was based on a "waterfall" formula in Section 6.2 of the LLC Agreement.

[236] Tr. of Post-Tr. Arg. 207:20-208:1.

judicial review. The LLC Agreement does not provide a dispute resolution mechanism for appraisals, unless they are made "at the end of a contract period," at which point either party may trigger the Appraisal Arbitration Process.[237] SHP claims that CalPERS deliberately avoided providing for such a dispute resolution process because it felt that, by picking the appraisers, it was adequately protected against the risk that the appraiser might produce a value that CalPERS thought was too high.[238] SHP notes that both parties were given the chance by the appraisers to, and did, comment on the draft appraisals before they were made final: this served as a safeguard against error to both CalPERS and SHP.[239] But, SHP argues, the contract does not contemplate any role for a court to second-guess the substantive judgment of CalPERS' selected appraisers.

In its briefing, SHP adopted a less stark position, and suggested that a court could review an appraisal by focusing on the "fairness of the . . . process, not the value conclusion."[240] Although it is vague about what it means, SHP seems to acknowledge that if a party to the contract had engaged in a bad faith effort to cause the appraiser to render a judgment that was not the result of unbiased professional judgment, such as by providing the appraiser with intentionally false information or exerting improper influence over the appraiser, the court could set aside the appraisal because it was the product of a contractual breach. As to the appraisals for the Incentive Distribution and the Asset Management Fees, SHP says that because CalPERS itself selected Duff &

[237] LLC Agreement Ex. Q § II.B.
[238] Tr. of Post-Tr. Arg. 209:12-210:3.
[239] *Id.* at 211:15-212:8.
[240] Pls.' Post-Tr. Ans. Br. 16.

Phelps and played the primary role in shaping its work, there is no basis for judicial review of Duff & Phelps's work. As to the appraisals for the Membership Interests, however, SHP suggests that this court should adjust the values of the Cushman & Wakefield appraisals, to undo the effect of the increase in the discount rate that Pottle forced Cushman & Wakefield to apply.

CalPERS has also adopted somewhat inconsistent positions on the judicial review of the appraisals. In its briefing, it argues that this court has must independently review the appraisals as if this were an appraisal under the DGCL.[241] CalPERS, relying on two cases of this court, argues that, if there is no dispute resolution process in the appraisal process that can be likened to an arbitration, this court has the "duty" to appraise the properties itself.[242] CalPERS is not entirely clear on whether it is necessary to "object" to the appraisals to maintain a right to judicial review, but suggests that this is important.[243]

At oral argument, CalPERS adopted a slightly less strong line, and conceded that, before this court undertook a *de novo* review, CalPERS had the burden to show that the contractually mandated appraisals were "flawed," whatever that means.[244] CalPERS argued that it had the right to seek a judicial review of the appraisals unless it "waived" this right, and that, in the case of the Original Duff & Phelps Appraisals, authorizing the final versions to be issued did *not* constitute a waiver.[245]

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[241] *See* 8 *Del. C.* § 262.
[242] Defs.' Post-Tr. Op. Br. 2, 42; Defs.' Post-Tr. Ans. Br. 24-25.
[243] Defs.' Post-Tr. Op. Br. 2, 42; Defs.' Post-Tr. Ans. Br. 24-25; Tr. of Post-Tr. Arg. 138:3-22.
[244] Tr. of Post-Tr. Arg. 145:18-20.
[245] *Id.* at 146:2-20.

In an odd argument, CalPERS has suggested, however, that the appraisal values that result from the LLC Agreement's Appraisal Arbitration Process should be reviewed more deferentially, as if they were actually arbitrations conducted under the Federal Arbitration Act.[246] This is intuitively odd because CalPERs is arguing that when the contract specifically contemplates the possibility for the parties to seek some form of substantive review of the appraisals, the scope for judicial review is *less* than when the contract contemplates no form of judicial review at all.

C. The Correct Standard Of Review

The gist of SHP's positions is essentially correct. A court may not second-guess the appraised values that have been committed by contract to determination by the appraisers, although a court may consider claims that the contractual appraisal process has been tainted by breaching conduct of one of the parties.

Delaware is a state that respects the freedom of contract.[247] Thus, when two parties have a contract on which a payment must be made, they are free to determine the

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[246] 9 U.S.C. §§ 1-16; *see* Tr. of Post-Tr. Arg. 138:15-19; Defs.' Post-Tr. Ans. Br. 24 n.23.

[247] *See, e.g.*, *CML V, LLC v. Bax*, 28 A.3d 1037, 1043 (Del. 2011) (noting that Delaware's Limited Liability Company Act "allow[s] interested parties to define the contours of their relationships with each other to the maximum extent possible"); *Parkcentral Global, L.P. v. Brown Inv. Mgmt., L.P.*, 1 A.3d 291, 296 (Del. 2010) (parties in a limited partnership "have broad discretion when drafting their partnership agreement"); *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010) ("Parties have a right to enter into good and bad contracts, the law enforces both."); *O'Brien v. Progressive N. Ins. Co.*, 785 A.2d 281, 286 (Del. 2001) (holding that, in the insurance context, "[p]arties . . . are free to agree upon any terms so long as that agreement is not inconsistent with a statutory prohibition or public policy"); *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072, 1146 (Del. Ch. 2012), *aff'd*, 45 A.3d 148 (Del. 2012) ("[Delaware's] public policy is pro-contractarian."); *Libeau v. Fox*, 880 A.2d 1049, 1056-57 (Del. Ch. 2005), *aff'd in relevant part*, 892 A.2d 1068 (Del. 2006) ("When parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement . . . .").

basis for that payment. For example, if parties determined that a contractual payout would be determined in part by rainfall on a particular day in a particular location, they could stipulate that the rainfall would be as reported by the National Weather Service. In such a case, however arbitrary the input, the court could not second-guess the rainfall measurement of the National Weather Service by hearing expert testimony on how much rain actually fell in that particular location on that particular date. Rather, the contractual input would be respected as the ones chosen by the parties. This is not to say that the court would uphold an unjust result. But injustice would not be based on an argument and a resulting judicial inquiry into the possibility that the National Weather Service in good faith made a measurement error. Such a substantive judicial reconsideration of the National Weather Service's measurement would be entirely inconsistent with the parties' own contract, which included as an input to a key formula the reported measurement of the National Weather Service, not the measurement of the National Weather Service subject to a *de novo* judicial re-examination. No, the only injustice that would be relevant in contractual terms would be if a party to the contract had tainted the National Weather Service measurement by giving a large bribe to the local official charged with reporting rainfall to the NWS. In that (unthinkable) case, the party suffering from that breach of contract would, of course, have the right to relief because the contractual input had been tainted by a breach of the implied covenant of good faith and fair dealing.[248]

[248] *See, e.g.*, *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) ("[T]he implied covenant [of good faith and fair dealing] attaches to every contract . . . .") (citation omitted). Under the implied covenant, the court must ensure that each party "refrain[ed] from

These distinctions are relevant in considering the present dispute. When parties bargain to have a contractual payment turn on the on the valuation of property, the parties are free to set whatever level of judicial review they like. As a first option, the parties may bargain for a *de novo* judicial determination of the value of the property if they cannot agree. That is, the parties can omit any kind of appraisal provision from the contract and simply provide that one input to the formula is fair market value, and implicitly leave this court to resolve the dispute, because the contract provides no other method to resolve any disagreement. Or, the parties can expressly state in the contract that this court is to resolve any dispute over the valuation of the property.

Second, as an interim position, contractual parties can, and often do, have the value of property (or analogous item, such as a tax payment) determined by a relevant expert, such as an investment bank or an accounting firm, *and* designate that expert as an arbitrator for that purpose.[249] When that is done, the very limited form of judicial review available under the Federal Arbitration Act ("FAA") is what the parties choose.[250] The grounds on which the judgment of such an arbitrator can be set aside are narrow, and

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arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." *Id.* (citations omitted).

[249] *E.g.*, *Omni Tech Corp. v. MPC Solutions Sales, LLC*, 432 F.3d 797 (7th Cir. 2005) (merger price was to be adjusted according to working capital of target company at the time of closing, and any disputes over such working capital were to be submitted to accountants, whose decision the court reviewed under the standards in the Federal Arbitration Act); *Fit Tech, Inc. v. Bally Total Fitness Hldg. Corp.*, 374 F.3d 1 (1st Cir. 2004) (accountants served as arbitrators in resolution of earnout payment in asset purchase agreement); *McDonnell Douglas Fin. Corp. v. Pa. Power & Light Co.*, 858 F.2d 825 (2d Cir. 1988) (parties submitted dispute over indemnity payment arising under preferred stock agreement to tax counsel); *Viacom Int'l, Inc. v. Winshall*, 2012 WL 3249620 (Del. Ch. Aug. 9, 2012) (contract provided that "resolution accountants" should resolve parties' disputes over the payout of an earnout, and that a court should review the accountants' figure under a standard very close to that of the Federal Arbitration Act).

[250] 9 U.S.C. §§ 1-16.

mostly go to the fundamental fairness of the arbitration process.[251] Importantly, FAA review does not involve the court examining whether the arbitrator's legal judgments were correct or that its factual determinations were supported by substantial evidence. Rather, an arbitrator's ruling can only be set aside on very narrow grounds, and the reviewing court does not have the same leeway to set aside an arbitrator's judgment as it would to set aside that of a trial court.[252]

The third contractual choice that the parties have is to use an appraiser to determine the value of the property to be used as an input into the payout formula. Parties can agree to have the value that will be used as a contractual input decided definitively and without substantive review by a contractually designated party. In such a case, there is *no judicial review if no provision for such review is provided in the contract itself*.[253] The court may, of course, review whether the parties otherwise faithfully

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[251] *Id.* § 10.

[252] "[A] court's review of an arbitration award is one of the narrowest standards of judicial review in all of American jurisprudence." *TD Ameritrade, Inc. v. McLaughlin, Piven, Vogel Secs., Inc.*, 953 A.2d 726, 732 (Del. Ch. 2008) (citation omitted).

[253] Some courts have held that the determination of a contractual input by a designated appraiser should be subject to judicial review under a standard equivalent to that used to review the work of a contractually-designated arbitrator. *See, e.g.*, *Safeco Ins. Co. v. Sharma*, 207 Cal. Rptr. 104 (Ct. App. 1984). I do not agree with this conclusion, but I note that these courts' approach is, in reality, much the same as the approach I adopt today. Under the Federal Arbitration Act, a court may vacate an arbitration award "where the award was procured by corruption, fraud, or undue means," or "where there was evident partiality or corruption in the arbitrators." 9 U.S.C. § 10(a). These situations would, I believe, be covered under the approach I take, whereby a court may review an appraisal for a breach of the implied covenant of good faith and fair dealing. The only occasion when the two approaches might diverge would be if a court that applied arbitration-style review modified the appraisal on the ground that there was an "evident material miscalculation of figures" or an "evident material mistake in the description of any . . . thing or property." *Id.* § 11(a). In practice, if the parties appointed a professional appraisal firm to appraise property, and were permitted to review draft appraisals, they would be likely to spot an "evident" mistake before the final appraisals were issued. This is what happened with the draft

applied the contractual formula to determine the payout, because that is not within the appraisers' narrower mandate.[254] But, the court may not substantively review the appraiser's determination of the value that the contract requires be used as an input to that formula. To do so rewrites the contractually defined input—which is set based on a value determined by the appraiser selected in accordance with the contract—and replaces it with a term supplied by judicial fiat and involving the appraiser's result just being a starting point for a *de novo* judicial inquiry into value.

The parties may also choose—by contract—to give themselves the right to dispute an appraiser's valuation, by providing for additional *appraisals* if a party disagrees with the result. This is not an arbitration, like the second option I have described above, although, like an arbitration, it requires the parties to be in dispute over the initial appraised value. The so-called Appraisal Arbitration Process established in the LLC Agreement is an example of this. Under that process, a party had the right to object to an

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Cushman & Wakefield appraisals in this case. Salzgeber Dep. 255:3-9 (discussing a mathematical error in the draft Cushman & Wakefield appraisals, which was pointed out by SHP, and corrected by the time the appraisals were finalized). Furthermore, even a final appraisal could be revised by the appraiser if such an evident error was made and pointed out by a party in a prompt and open way, as such a change would involve no contractual impropriety, because it would involve the appraiser fixing an acknowledged computational error, not adjusting its substantive judgment on account of a party's pressure.

[254] *See, e.g.*, *Marceron v. Chevy Chase Servs., Inc.*, 258 F.2d 155 (D.C. Cir. 1958). In *Marceron*, the parties were disputing the rent payment on a tract of land in Washington. The rental formula that the parties had agreed depended on the appraised value of the land, as determined by a panel of three appraisers. Then-Circuit Judge Burger ruled that the appraisers' value determinations were "clothed with [a] presumption of correctness," but that the appraisers' construction of the formula for determining the rent was not. *Id.* at 158.

The contract in *Marceron* explicitly provided that the appraised value should be binding on the parties. The LLC Agreement does not make this explicit, but the extrinsic evidence shows that the parties in this case viewed the appraised values as binding. *E.g.*, JX 648 (letter from Fred Minnes to Al Grijalva (Jan. 10, 2008)) (noting that there was no way to challenge the Original Duff & Phelps Appraisals).

appraised value, when the appraisal was carried out at the end of a contract period. That party could then pay for another appraisal to be carried out by an appraiser from CalPERS' approved list. If the first and second appraisals were within 5% of each other, the values were averaged; otherwise, the first two appraisers were to select a third appraiser, again from CalPERS' list, to value the Projects. The final value was the average of the appraisals that were within 5% of the middle appraisal, or the middle appraisal alone, if that was all that was left. This kind of procedure, which contractually provides for additional appraisals in the event of a dispute, should be treated in the same way as a process that contractually provides for a single appraisal without one party having to dispute it: the contract does not contemplate any judicial review, because the iterative contractual process itself provides a definitive resolution.

De novo review of the appraisals in this case is thus inconsistent in that circumstance with the most central rule of contract interpretation, which is that a contract must be interpreted in accordance with its plain terms as they would normally be understood.[255] When a contract plainly says that a contractual input (the value of a certain property) will be determined by an appraiser selected in accordance with the contract's terms, that is what it plainly means. It is contrary to such a plain reading for the appraiser's value to be subject to judicial second-guessing. *De novo* judicial review is also inconsistent with commercial logic. When parties contractually decide to have a qualified expert with relevant credentials make a determination of value without any

[255] *See Seaford Golf & Country Club v. E.I. duPont de Nemours & Co.*, 925 A.2d 1255, 1261 (Del. 2007); Restatement (Second) of Contracts § 202(3)(a) (1981).

indication that the expert's judgment is subject to judicial review, on what basis would it make sense to infer that the parties intended to have a law-trained judge do a *de novo* review of the expert's determination? Such second-guessing is inconsistent with the obvious premise for having an expert with relevant credentials decide the matter for purposes of establishing the contractually binding input.[256]

This conclusion is supported by a federal decision in analogous circumstances. In *Hoskins Lumber Co. v. United States*, the United States Court of Appeals for the Federal Circuit was faced with the question of whether one party could object to an appraisal carried out in accordance with the terms of a government timber contract.[257] The court held:

> The terms of [the appraisal provision of the contract] make it clear that the only appraisal to which [the plaintiff] was entitled was one that complied in all material respects "with the standard Forest Service method in use at [the] time of the termination" of the timber contract. [The plaintiff] was emphatically not entitled to a "fair" appraisal, an "accurate" appraisal, a "reasonable" appraisal, or any manner of appraisal other than the one indicated in [the contract]. Under [the contract], compliance with the

[256] My decision in this case is thus consistent with the court's approach in the 2010 case of *Julian v. Julian*, 2010 WL 1068192 (Del. Ch. Mar. 22, 2010). In *Julian*, parties to a contract had entrusted to appraisers the responsibility of valuing real estate, the value of which was inputted into a "Pricing Formula" that was then used to calculate the value of a company's stock. The Pricing Formula provided that, if one party disputed the appraisal value, that party had the right to obtain its own appraisal, and the two appraisals would be averaged. *Id.* at *11. When the parties contested the appraised value in this court, both accepted that the appraisers' average value should be accorded the deference given to an arbitrator's ruling. Because the parties agreed that this was the case, Vice Chancellor Parsons did not have occasion to determine whether that was correct. But the Vice Chancellor noted that the parties had "established a quick, clear, binding, and relatively simple dispute resolution mechanism, presumably to prevent costly litigation." *Id.* This logic applies to all the appraisals that the parties contracted for in this case, as well as appraisals more generally: there is no reason why a court should review the merits of the appraisals when the parties have contracted for the appraisals so that a court will *not* get involved.
[257] 89 F.3d 816 (Fed. Cir. 1996).

> standard appraisal method is the sole measure of its accuracy and reliability.[258]

Even in this scenario, however, it is not the case that a party bound by an appraiser's determinations has no procedural protections. In such a scenario, it is a contractual expectation that the appraiser make a good faith, independent judgment about value to set the contractual input. If one of the parties to the contract takes action to taint the appraisal process—for example, by providing the appraiser with false financial statements—a court can of course protect the injured party. Such judicial review would not, however, involve second-guessing the good faith judgment of the appraiser or examining the appraiser's valuation judgments for consistency with a judge's understanding of relevant corporate finance principles. It would instead involve a judge determining that a party had breached the contract's implied covenant of good faith and fair dealing,[259] and that this breach, as its proximate result, deprived the appraiser's work of contractual integrity. Thus, judicial review is not unavailable, but is restricted to considering a claim that the appraisal is unworthy of respect because it does not, as a result of contractual wrongdoing, represent the genuine impartial judgment on value that the contract contemplates.

On this gradation of contractual choice, this third scenario is the one that the parties under the LLC Agreement chose. In the LLC Agreement, the parties bargained for appraisals carried out by CalPERS-appointed appraisers who were Members of the Appraisal Institute and would apply the Uniform Standards of Professional Appraisal

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[258] *Id.* at 817.
[259] *E.g.*, *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005).

Practice (USPAP) of the Appraisal Foundation.[260] The results of these appraisals were used as an input to the formula to set the Incentive Distribution. The LLC Agreement is entirely silent as to the possibility of a court disturbing the results of the appraisals and makes no room for substantive second-guessing of the appraiser's good faith determination.

Even though the LLC Agreement is in my view unambiguous that no judicial review is permitted as to the contractual appraisal value, a review of the parol evidence does not aid CalPERS' contrary view.[261] In January 2008, Fred Minnes, the CalPERS Real Estate Unit counsel, wrote to CalPERS that "*there is no procedure in the Limited Liability Company Agreement that gives CalPERS the right to reject an appraisal.*"[262] Because of this, the objection letter that Minnes drafted for CalPERS did not contain any justification for CalPERS' rejection of the appraisals, and, when questioned about this by CalPERS staff, Minnes replied, "I would let SHP figure out by itself on what basis under the Limited Liability Company Agreement CalPERS has the right to object."[263] Thus, CalPERS cannot argue now that the appraiser that it, *CalPERS*, appointed to value the Projects got the Projects' value wrong. CalPERS may believe that the appraiser should have been more prescient in anticipating further sharp declines in the Florida housing market and the financial crisis itself, or should have used a different cost of capital. But its own plain contractual formula precludes its attempt to have a judge address those

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[260] LLC Agreement Ex. Q § II.A.
[261] *See, e.g.*, *GMC Capital Invs., LLC, v. Athenian Venture P'rs I, L.P.*, 36 A.3d 776, 784 (Del. 2012) (discussing the parol evidence rule).
[262] JX 648 (letter from Fred Minnes to Al Grijalva (Jan. 10, 2008)) (emphasis added).
[263] JX 649 (email from Fred Minnes to Javier Plasencia (Jan. 10, 2008)).

valuation questions and substitute his judgment in place of the contractually designated authority to set that contractual input.[264]

D. CalPERS' Arguments To The Contrary Are Not Convincing

CalPERS nonetheless argues that prior Delaware precedent "require[es] the Court to independently determine the appropriate value" of the Projects, because CalPERS now disputes the appraised values produced by Duff & Phelps and Cushman & Wakefield.[265] But, a close reading of that precedent suggests that it cannot be fairly read to stand for the extraordinary proposition that CalPERS advances, which is that when parties bargain for an expert's determination of a contractual input and do not subject that determination even to the limited review available in arbitration, they are impliedly bargaining that the input can be set aside merely because a non-expert judge takes a different review on *de novo* review. Rather, I believe that both the cases CalPERS relies on can be fairly read as supporting the proposition that a contract using an appraisal to set an input must be enforced according to its terms. Such terms do not allow for second-guessing of the appraisal. But, they do require the judiciary to hear a claim that the integrity of the contractual appraisal process was compromised by the wrongdoing of one of the parties.

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[264] The doctrine of the construction of a contract against the drafter would typically preclude the interpretation that CalPERS now adopts. *See Kuhn Constr., Inc. v. Diamond State Port Corp.*, 990 A.2d 393, 397 (Del. 2010); Restatement (Second) of Contracts § 206 (1981). But, CalPERS' form drafters were canny, and the LLC Agreement contains a provision waiving "any rule of law . . . that would require interpretation of any ambiguities in this Agreement against the party that has drafted it." LLC Agreement § 9.18.

[265] Defs.' Post-Tr. Op. Br. 2.

The more recent of the two cases that CalPERS relies on is *Morris, Nichols, Arsht & Tunnell v. R-H International, Ltd*.[266] In that case, the plaintiff, a tenant, challenged an appraisal of its offices that was submitted by the defendant, the plaintiff's landlord, in advance of renewing the lease. Under the parties' tenancy agreement, before the lease was renewed, each party had the right to submit an appraisal of the building's rental value. If the appraised values differed by a small amount, they were averaged; if they differed more widely, the parties' appraisers would engage a third appraiser, and all three appraisals would be averaged.

The plaintiff in *Morris, Nichols* alleged that the defendant had submitted a fraudulently high appraisal value because it knew that even if the dispute resolution mechanism was triggered, this high value would still be included in the averaging of the appraised values. The defendant moved to stay or dismiss the case on the ground that the appraisal process, which the defendant likened to an arbitration, was still pending, and that "in arbitration judicial review is permitted only after a final award has been entered by the arbitrator."[267] The court denied the motion to dismiss on the ground, stating that "an appraisal procedure is not the equivalent of arbitration and . . . this Court is not limited in its review of an appraisal as it would be in the case of arbitration."[268]

CalPERS claims that the *Morris, Nichols* case supports the proposition that a court need not give any deference to an appraisal award, and may review it *de novo*. This interpretation of *Morris, Nichols* makes little sense: parties would not include appraisal

[266] 1987 WL 33980 (Del. Ch. Dec. 29, 1987).
[267] *Id.* at *4.
[268] *Id.*

provisions in their contracts if they believed that a court would simply disregard the appraisal if one party objected. The issue in the *Morris, Nichols* case was not whether the court had the authority to review *de novo* the substantive work of a contractually designated appraiser that was not tainted by contractual misconduct by a party. The issue was whether the court could consider a claim that the contractual appraisal process had been undermined by contractually improper conduct.[269] The approach this opinion takes is therefore consistent with *Morris, Nichols*.

The second decision CalPERS relies on is *Collison v. Deisem*, which is over forty years old.[270] This opinion admittedly gets closer to the position CalPERS advances, but in my view is neither controlling on its facts, nor should its reasoning be taken out of the unique context in which it was employed. *Collison* was a will contest over the disposition of shares in a small business that the testatrix had determined would be decided by a three-person board of appraisers. The will had specific factors the appraisers were supposed to consider and apply. When a party challenged the resulting value as far too low, the plaintiffs sought summary judgment against the executor, arguing that the court could not review whether the appraisers had made a mistake. In rejecting this broad contention, the court suggested that even an arbitrator's ruling was subject to narrow review and that there was, in the court's view, a "more compelling" reason for review where an appraisal board under a will made a decision without any

[269] *See id.* at *3 (discussing the plaintiffs' claim for breach of good faith).
[270] *Collison v. Deisem*, 265 A.2d 57 (Del. Ch. 1970).

record of why it made its decision.[271] Because the record contained facts that suggested that the appraisal board had not genuinely considered the factors the will directed them to consider, but had simply jawed for a short time about value and then split the differences among their top-of-the-head estimates, the court noted that the "result was an arbitrary cut-down-the-middle" and not "that [was] not the standard specified by [the testatrix.]"[272]

This terse three-page decision involved a context quite different from the one here, where sophisticated commercial parties chose a valuation firm to set a contractual input and that firm delivered a formal appraisal applying recognized corporate finance principles. *Collison* did not deal with such a case or the implications of second-guessing the contractual parties' chosen appraiser's value. Furthermore, the substantive reasoning of *Collison* does not turn on second-guessing of the kind CalPERS seeks here, where it seeks to have the court second-guess the good faith valuation judgments made by the contractual appraiser. Instead, it involved the court being willing to examine whether the contractual appraisal process was carried out with fidelity. Having been presented evidence that the appraisers did not honor the testatrix's direction as to the factors to be considered in determining value and instead just flippantly agreed to an unreasoned compromise value, this court, acting as a court of equity to enforce the wishes of a testatrix who was of course not around to speak for herself any more, upheld her binding written directions by denying summary judgment to hold a final factual hearing on whether the will had been implemented with integrity. By contrast, here CalPERS seeks

[271] *Id.* at 59.
[272] *Id.* at 60.

de novo review of the expert appraisers whose decision as to the Fair Market Value of the Projects is, under the plain language of the CalPERS form contract, which provides for judicial review in other situations but not here, the final determinant of a contractually defined input to a formula.

* * *

My resolution of this issue settles much of the case. CalPERS may not object to the appraised Fair Market Values of the Projects simply because it does not like them. Therefore, the Fair Market Value determined by the appraisers must be used as an input to the contractual formulas that determine the Incentive Distribution, Membership Interests, and Asset Management Fees.

I now turn to SHP's individual claims.

V. The Incentive Distribution

The parties dispute three inputs into the formula that is used to calculate the Incentive Distribution. These are the appraised value of the Projects; the cash that the Fund returned to CalPERS in the form of Distributions between 2003 and 2007; and the hurdle rates against which the Fund's internal rate of return should be compared.

A. CalPERS' Claim That SHP Breached The LLC Agreement By Supplying Duff & Phelps With Inflated Projections

As I have explained, under the standard of review I adopt today, the LLC Agreement leaves no room for review of the substantive work of the appraisers. Their determination is what the parties bargained for and it is binding. The only room for judicial review is to ensure that the contractual process was not undermined by breaching action of one of the parties. Therefore, if CalPERS wishes me to alter or replace the Original Duff & Phelps Appraisals for use in the Incentive Distribution, it must show that there has been such a breach of the implied covenant.

Only one of CalPERS' attacks on the Incentive Distribution can be construed as such a claim. This is CalPERS' claim that SHP misled Duff & Phelps by giving Duff & Phelps overly bullish projections of the Projects' future performance. CalPERS argues that the actual performance of the Projects turned out to be worse than the performance that SHP predicted, and so SHP is responsible for inflating the value of the Original Duff & Phelps Appraisals.

But CalPERS' argument is not convincing. The record is clear that *Duff & Phelps made its own projections*.[273] Enright warned both Ross Prindle, Duff & Phelps's managing director in charge of the SHP appraisals, and David Baldwin, who led the Duff & Phelps team, to be wary of SHP's projections, because CalPERS believed that they would be too optimistic.[274] Both Prindle and Baldwin testified that they took care that their projections were "absolutely independent," even though they had to interact with SHP in order to produce the projections.[275] The record shows that Duff & Phelps produced much lower projections than SHP supplied to it.[276] In other words, there is no

[273] Baldwin Dep. 48:3-4 ("Based on the information and anticipated move-ins, we made our projections."); *see also* Prindle Dep. 39:14-22 (confirming that Duff & Phelps did its due diligence on the information it received).

[274] JX 587 (email from Ross Prindle to David Baldwin (Oct. 19, 2007)) ("Listen to this [voicemail], sounds like they don't trust Craig"); Tr. 393:10-396:7 (Enright).

[275] Baldwin Dep. 56:22-57:5; Prindle Dep. 39:16-24.

[276] For example, Duff & Phelps estimated that there would be 789 move-ins between 2008 and 2012, 22% fewer than SHP estimated. *Compare* JX 665, at 108, JX 666, at 109, *and* JX 667, at 109 (Original Duff & Phelps Appraisals of independent living Projects), *with* JX 615, at 15, 52,

basis to conclude that SHP's more optimistic views unfairly biased Duff & Phelps's appraisals. As important, CalPERS has not demonstrated that SHP's projections were made in bad faith. The fact that the market turned is something that very sophisticated parties—indeed CalPERS—failed to predict, but is no evidence of bad faith.

In this respect, it is notable that CalPERS' argument relies on data from 2010 to argue that SHP's projections were inaccurate.[277] Just as it is inappropriate to use future, unknown information in a retrospective appraisal, so it is inappropriate to use this information to critique an appraisal.[278] Indeed, if we could know the future with certainty, irrational pricing bubbles would not occur. Real estate and stock market bubbles eventually pop, but the market values that create them are real as of that time. CalPERS *itself* was hoping to benefit from the bubble when it went heavy into real estate investments and it proudly touted the bubble values of its real estate portfolio to the public, before and after it burst. CalPERS' reluctance to pay an Incentive Distribution

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66 (email from Andre Maksimow to Monica Chan, Duff & Phelps (Dec. 5, 2007)) (containing SHP's projections).

[277] Defs.' Post-Tr. Ans. Br. 17-18.

[278] *See, e.g.*, *Gentile v. Rossette*, 2010 WL 217163, at *2 (Del. Ch. May 28, 2010); *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *8 (Del. Ch. July 9, 2004), *aff'd in relevant part*, 884 A.2d 26 (Del. 2005); *Agranoff v. Miller*, 791 A.2d 880, 891-92 (Del. Ch. 2001); *Le Beau v. M.G. Bancorporation, Inc.*, 1998 WL 44993, at *10 (Del. Ch. Jan. 29, 1998). CalPERS devotes a long footnote in its post-trial opening brief to justifying the use of retrospective data, but its position is mistaken. Defs.' Post-Tr. Op. Br. 45 n.29. CalPERS quotes the USPAP guidelines as providing that "[d]ata subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date." *Id.* (quoting JX 433, at 85-86 (USPAP Statement on Appraisal Standards No. 3 (2006))). But, the appraisals in this case were not retrospective. Under the USPAP terminology, the appraisals were "current," because the appraisers valued the properties at (or very close to) the date at which the appraisal reports were issued. JX 433, at 85. Therefore, CalPERS' reliance on the USPAP guidelines is misplaced.

based on a 2007 valuation date by trying to focus on the wreckage that occurred in 2008, while understandable, is improper as a matter of valuation and financial logic.

B. CalPERS' Substantive Attacks On The Merits Of The Original Duff & Phelps Appraisals

My analysis so far is enough to settle the question of what appraisals must be used to calculate the Incentive Distribution. But, the issue of the standard of review in this case is a relatively unique one. The Supreme Court may be of a different view. Because the substantive valuation issues were warmly contested and are fresh in mind, judicial efficiency and concern for the parties' ability to get this dispute behind them counsels in favor of addressing, in the alternative, CalPERS' substantive attacks on the Original Duff & Phelps Appraisals. CalPERS attacks the Original Duff & Phelps Appraisals primarily because Duff & Phelps supposedly failed to account correctly for the resident liabilities. CalPERS makes this same criticism of all the other appraisals that CalPERS commissioned. In addition, CalPERS makes some more minor attacks on individual pieces of data that Duff & Phelps used.

1. The Judicial Second-Guessing CalPERS Demands Of Its Own Appraiser's Judgment Does Not Suggest That The Appraiser Made Any Mistake In Judgment In Taking The Resident Liabilities Into Account

As I have discussed, the total, fee simple, value of the Projects was divided into a leased fee interest, which belonged to the Fund, and a leasehold interest, which belonged to the residents. As of the end of 2007, Duff & Phelps valued the leased fee interest at \$346 million, and the leasehold interest at \$67 million. The treatment of this leasehold interest was debated vigorously in the briefing, trial, and post-trial argument.

The witnesses in this case have used the term "leasehold interest" in two different ways. The narrower definition refers only to the 50% of the initial entrance fees that are refundable when the residents die or move out.[279] A slightly broader definition of the term includes both the 50% entrance fee refund and the residents' ongoing right to receive board, lodging, and healthcare.[280] Under the residents' contracts, this ongoing board, lodging, and healthcare was covered by the residents' monthly fees, and was an obvious reality of the business model for senior housing facilities: after all, what the residents were getting for their payments was the right to remain in the Projects until they died. Thus, the 50% entrance fee refunds represented a much more material future liability than the residents' ongoing right to receive services, and the parties' arguments on the valuation of the leasehold interest focused on the entrance fee refunds.

Regardless of the precise definition of "leasehold interest," it is clear that it is an asset for the residents, and also represents, in some sense, a liability to the Fund, because the Fund has to repay the refundable entrance fees and provide the services to which the residents are entitled. The parties disagreed on how, under the LLC Agreement, the leasehold interest should be accounted for in the determination of the Fair Market Value.

SHP has consistently taken the view that the relevant figure for the amount that a buyer would pay for the Projects, *i.e.*, their Fair Market Value, is the *leased fee interest alone*, which represents the buyer's interest in the property. Thus, according to the Original Duff & Phelps Appraisals, a buyer would have paid $346 million in cash for the

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[279] *E.g.*, Anderson Dep. 77:14-25.
[280] *E.g.*, Boehm Dep. 197:6-198:4.

Projects at the end of 2007. SHP's argument is logical. SHP acknowledges that the Fund has an obligation to repay entrance fees and provide services, but points out that Duff & Phelps, like all the other appraisers CalPERS commissioned to appraise the Projects, took such obligations into account when they performed a discounted cash flow analysis of the properties.[281] In general, the cost of refunding an entrance fee is covered by the new entrance fee paid by a new resident, and the cost of board and lodging is covered by the monthly fees that the residents pay. Because the discounted cash flow analysis models all of these cash flows, the value of the leased fee interest takes into account the fact that the Fund has ongoing obligations to deceased and current residents. The model also reflects that these obligations are generally self-funding: new entrance fees cover old entrance fees, and the residents' living costs are covered by their monthly rent.

Because the obligations to the residents are accounted for in the valuation of the leased fee estate, SHP points out that it would be illogical to *deduct* the value of the refundable entrance fees from the value of the leased fee estate to arrive at a value that a buyer would pay. Rather, because the fee simple estate is the sum of the leased fee estate and the leasehold, the value of the leasehold estate should be deducted from the *fee simple* interest to arrive at the leased fee interest. But, the leasehold interest cannot be deducted again from the leased fee interest. This is a simple arithmetical proposition, but, because CalPERS has disputed it, I note that the defendants' expert, Michael Boehm, admitted this reality at trial, albeit in an extremely evasive way.[282]

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[281] *E.g.*, JX 665, at 105-06 (Lake Port Square appraisal report (Dec. 15, 2007)).
[282] *See* Tr. 1047:6-1055:21 (Boehm – Redirect).

SHP's position thus reflects the market reality that the purchaser of a senior housing community will assume the resident liabilities as part of the purchase consideration. At trial, both Boehm and Ganns, CalPERS' consultant, testified that a buyer would assume the resident liabilities.[283] Eastdil Secured, the firm that CalPERS hired to perform a broker's opinion of value, also stated that a buyer would assume the resident liabilities.[284]

CalPERS has taken four different positions as to the correct treatment of the resident liabilities. *Before this litigation*, and while CalPERS was dealing with SHP under the LLC Agreement, CalPERS agreed with SHP's approach. That is, CalPERS believed that a buyer would pay for the leased fee interest, and would assume the resident liabilities, because the impact of these had been incorporated into the valuation of the leased fee. When CalPERS challenged the Original Duff & Phelps Appraisals, it did not object to SHP's method of accounting for the residents' interest.[285] In a hypothetical liquidation framework that Fred Minnes drew up for Anderson, Minnes noted that the leased fee values that the appraisers produced should be used for the "[r]eal estate fair market value": this figure "[t]akes into account 'resident bonds and entrance fee liabilities' so those are excluded from Liabilities."[286] *And, in its public filings, CalPERS*

[283] Tr. 915:19-23 (Ganns – Cross); Tr. 1057:7-8 (Boehm).
[284] JX 745 (memorandum from Lisa Widmier, Eastdil, to Steve Ganns (May 28, 2008)).
[285] *See* JX 923 (letter from Ross Prindle to Dan Enright (Oct. 9, 2008)).
[286] JX 1116 (email from Randy Pottle to Craig Anderson (Dec. 5, 2008)).

reported the value of its interest in the Fund based on the leased fee value, and did not make any deductions from this figure to take into account the leasehold interest.[287]

The parties' course of performance under a contract is a powerful indication of what the correct interpretation of that contract is.[288] Thus, even though the LLC Agreement did not spell out the methodology for appraising the Projects, CalPERS' implicit acceptance that a purchaser would assume the resident liabilities is strong evidence that the parties contemplated that the fees payable under the LLC Agreement would be calculated on this basis. CalPERS has argued that this court should not place weight on its public filings containing appraisals with this approach, because the value of the Fund was "insignificant" in the context of CalPERS' overall real estate holdings ($22 billion).[289] CalPERS' blithe disavowal of the reliability of its public disclosure is unconvincing and dismaying, especially because the total value reported is only as reliable as the various project appraisals it incorporates. As important, the reality is that CalPERS attended closely to the appraisal process of the Projects and reviewed the appraisals annually. CalPERS' belated view on this issue is inconsistent with its prior approach that a purchaser would assume the resident liabilities, and is a litigation-driven afterthought to justify its desire not to pay SHP the Incentive Distribution.

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[287] *See* JX 1561-66 (CalPERS' Real Estate Quarterly Performance reports (May 2008 – Aug. 2009)).
[288] *See, e.g.*, *GMC Capital Invs., LLC, v. Athenian Venture P'rs I, L.P.*, 36 A.3d 776, 784 (Del. 2012).
[289] Defs.' Post-Tr. Op. Br. 51.

During this litigation, CalPERS adopted yet a second theory. CalPERS' valuation expert, Boehm, valued the leased fee value of the Projects.[290] Boehm took into account the need to repay entrance fee liabilities in his appraisals.[291] This value was then used by CalPERS' accounting expert, John Garvey, to determine the net asset value of the Projects for the purpose of the Incentive Distribution.[292] Garvey deducted from Boehm's leased fee value the refunds that would be due to deceased or departing residents.[293] Thus, Garvey deducted from the leased fee value a large portion of the leasehold interest. Garvey ignored the fact that Boehm had already accounted for the ongoing refunds of entrance fees to deceased or departing residents in his discounted cash flow analysis. When SHP asked Garvey at his deposition in October whether Boehm had already taken the need to refund the entrance fees into account in his Fair Market Value appraisal, Garvey admitted that he did not know.[294] Garvey then testified that he believed it was necessary to deduct resident liabilities from Boehm's fair market valuation.[295]

Faced with this major mistake in its expert report, CalPERS adopted yet a third theory. Two months after his deposition, and only ten days before trial, Garvey attempted to revise his expert report by adding back on to his original determination of

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[290] Boehm stated that he was valuing the "market value of the fee simple total going concern." *E.g.*, Boehm Regency Oaks Appraisal, at 2 (Mar. 27, 2012). This is similar to the terminology used by Cushman & Wakefield, which appraised the "Market Value of the Fee Simple estate . . . as a going concern." *E.g.*, JX 1122, at 3 (Regency Oaks/Sylvan Health Properties appraisal report (Dec. 5, 2008)).
[291] *E.g.*, Boehm Report app. 2, at 91.
[292] Garvey Report ¶ 126.
[293] *Id.* ¶¶ 128-32.
[294] Garvey Dep. 258:20-25.
[295] *Id.* 259:19-260:1.

the net asset value of the Projects an "occupancy fee receivable" of $36 million.[296] This occupancy fee receivable was the payment to which the Fund was entitled from deceased or departed residents who had purchased bonds under the Projects' bond program that was discontinued in 2003. In the revised exhibits he submitted, Garvey did not identify any logical basis for deducting $129 million of residents' interest but adding back an occupancy fee receivable.[297]

Over the course of trial, CalPERS abandoned its "double deduction" theory. Nor did it make any serious attempt to defend its "modified double deduction theory," *i.e.*, Garvey's view that the entrance fee refunds should be deducted from the leased fee value but that bond receivables should be added back on. Rather, *in its post-trial briefing*, CalPERS adopted a fourth theory: a "credit" theory. Under this theory, a buyer would be given a credit—*i.e.*, a discount from the appraised leased fee value—for assuming the residents' liabilities. This theory is essentially an effort to split the difference between CalPERS original (and correct) view that a buyer would assume the resident liabilities, and CalPERS' second theory that the resident liabilities need to be deducted from the leased fee value to arrive at the Fair Market Value.

In support of its theory, CalPERS puts forward four "data points." The first two data points, of 19% and 40%, represent the difference between the consideration paid for the Projects and appraisals carried out near in time to the purchase of the Projects. [298] The third data point, 61%, is based on the difference between the fair value and the face value

[296] Tr. 824:11-826:19 (Garvey – Cross).
[297] *See* Garvey Report rev. Exx. 6-8.
[298] Defs.' Post-Tr. Op. Br. 29.

of the resident liabilities.[299] The fourth data point, 10%, is based on a memorandum written by Eastdil in 2008, in which Eastdil "anticipate[d]" that a prospective purchaser might demand a credit of approximately 10% of the resident liabilities "due to the soft home sale market environment in Florida and the heightened risk that units will not be resold."[300]

None of CalPERS' "data points" provides convincing evidence that Duff & Phelps, or any of the other appraisers who had adopted the same approach, failed to value the Fair Market Value of the Projects as that term was defined by the LLC Agreement, and is commonly understood—the price the Projects would be sold for in an arms-length sale on the open market.[301] As to the first two data points, there is no evidence that SHP obtained a favorable purchase price on the Projects because it was given a credit for the resident liabilities. Rather, Anderson testified at trial that SHP obtained the Projects at less than market price because the sellers did not want to run a public sale process and so SHP did not "have to bid in a competitive process."[302] As to the third data point, the difference between the face value and the fair value of the resident liabilities is irrelevant. This difference affects the valuation and accounting treatment of the leasehold interest, not the leased fee interest. CalPERS' fourth data point, unlike the other three, actually represents an estimate of the kind of credit that CalPERS is now advocating. But,

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[299] *Id.*
[300] JX 745 (memorandum from Lisa Widmier, Eastdil, to Steve Ganns (May 28, 2008)); Defs.' Post-Tr. Op. Br. 30.
[301] LLC Agreement Ex. Q § II.A.
[302] Tr. 12:19-13:5 (Anderson).

CalPERS ignores Eastdil's conclusion that "we think that we can identify a strategic buyer who will not require any credit."[303]

Thus, CalPERS has not shown that the Fair Market Value of the Projects, as defined under the LLC Agreement, would include any kind of credit off the appraised value of the leased fee interest. Therefore, even if I did have the power to review the appraisals *de novo*—which I do not—I would reject all of CalPERS' attacks on the Original Duff & Phelps Appraisals that are based on the treatment of the resident liabilities.

2. <u>CalPERS' Other Attacks On The Merits Of The Original Duff & Phelps Appraisals</u>

For the sake of completeness, I briefly address CalPERS' two other attacks on the Original Duff & Phelps Appraisals, and show why they would not justify modifying the Appraisals even under an intensive level of judicial review. First, CalPERS challenges Duff & Phelps's terminal capitalization rate of 9.5%, which Duff & Phelps used in both their Original and their Restated Appraisals.[304] CalPERS cites Boehm for the proposition that the terminal capitalization rate can be calculated from the discount rate, the overall capitalization rate, and the annual cash flow growth rate.[305] CalPERS then uses Duff & Phelps' own figures estimates of these three latter rates to try to show that Duff & Phelps should have used a lower terminal capitalization rate. But, Boehm's difference with Duff

[303] JX 745, at 2.
[304] *E.g.*, JX 667, at 6 (Original Duff & Phelps Appraisal of Regency Oaks (Dec. 15, 2007)); JX 1084, at 6 (Restated Duff & Phelps Appraisal of Regency Oaks (Dec. 3, 2008)).
[305] *E.g.*, Boehm Report app. 6, at 4.

& Phelps seems to be nothing more than a difference of academic opinion.[306] And, in any case, Boehm is relying on after-the-fact data that no appraiser could have known at the time, as he concludes that "the subject was experiencing significant declines in occupancy in late 2007 and overall market conditions/local real estate prices were deteriorating in late 2007."[307]

Second, CalPERS faults Duff & Phelps for using low projections of capital expenditures to maintain the units. In their Original Appraisals, Duff & Phelps estimated "capital reserves for replacement" at $350 per unit per year.[308] Boehm quoted a 2007 industry survey for the statistic that the median capital expenditure for CCRCs was $1,400.[309] But, SHP has pointed to evidence that the difference is explained by the fact that Duff & Phelps had a separate line item for "capital expenditures," and its "replacement reserves" were only for routine maintenance.[310] Thus, even if I were to review the substantive merits of the Original Duff & Phelps Appraisals—which I do not—they would pass muster.

C. The Distributions Of Cash To CalPERS Through The Cash Management System

The second issue as to the Incentive Distribution that the parties dispute is the "Distributions" of cash to CalPERS over the Calculation Period. CalPERS argues that SHP failed to transfer cash to it in accordance with the terms of the LLC Agreement, and

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[306] *See id.* (citing "our experience" as a basis for the formula to calculate a terminal capitalization rate).
[307] *Id.*
[308] *E.g.*, JX 665, at 112-13 (Lake Port Square appraisal (Dec. 15, 2007)).
[309] Boehm Report app. 6, at 4.
[310] *E.g.*, JX 665, at 118.

therefore SHP may not class any distributions of cash from the Fund to CalPERS as "Distributions" for the purposes of the Incentive Distribution. SHP argues that it did comply with the terms of the LLC Agreement, and that CalPERS knew, and approved of, its treatment of distributions of cash.

I reject CalPERS' complaint that SHP breached the plain terms of the LLC Agreement, because the Agreement was ambiguous. I then explain why the parties' course of performance shows that both CalPERS and SHP believed that SHP was making "Distributions" to CalPERS for the purposes of the Incentive Distribution. Thus, SHP's position is correct.

1. The LLC Agreement's Instructions On The Cash Management System Were Ambiguous

The Incentive Distribution is driven by the Projects' "Cash Outflows" and "Cash Inflows." Cash Outflows are defined as "all Capital Contributions funded by the Members pursuant to this Agreement during the Calculation Period," and Cash Inflows are defined as "all Distributions actually received by the Members pursuant to this Agreement during the Calculation Period."[311] A Distribution is defined as "any cash payment . . . distributed by the Company to [a] Member on account of its Membership Interest."[312]

Section 7.6 of the LLC Agreement provides how cash is to be distributed to the parties:

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[311] LLC Agreement Ex. H § 4.A.
[312] *Id.* § 1.1(a).

> Management of cash shall be the responsibility of [SHP] and [SHP] agrees to manage cash in accordance with such cash management procedures and policies established by CalPERS. [SHP] shall be responsible for causing one or more bank accounts of the Company [*i.e.*, the Fund] to be maintained in an FDIC-insured bank (or banks), which accounts shall be used for the payment of the expenditures incurred in connection with the business of the Company. All deposits and funds shall be swept daily to Company accounts maintained by CalPERS as part of CalPERS' cash management system with Bank of America. On a monthly basis, [SHP] shall instruct the Bank of America to remit to CalPERS, SHP and SHCLLC their respective portions of Cash Available for Distribution. CalPERS shall credit the Company monthly with interest at the same rate earned by CalPERS on the funds invested in CalPERS' cash management system. All amounts in Company accounts (including funds in CalPERS' cash management system) shall be and remain the property of the Company, and shall be received, held and disbursed for the purposes specified in this Agreement.

SHP and CalPERS agree that SHP accounted for cash flows to CalPERS' cash management system as Distributions to CalPERS without asking Bank of America to "remit" CalPERS' its share of the cash, as provided by the language of Section 7.6. But, Section 7.6 is ambiguous, and does not resolve the dispute in CalPERS' favor. Although Section 7.6 provides that SHP is to instruct Bank of America to remit Distributions of cash to the Fund members, the same section also provides that SHP is "to manage cash in accordance with such cash management procedures and policies established by CalPERS." CalPERS' Cash Management Policies and Procedures Manual, which came into force in July 2003, provided that there were two kinds of Distribution: "Bank Account Distributions," defined as "deposits made by the partners into the collection account for ordinary income," and "State Street Bank Distributions," which were "deposits made by the partners to State Street Bank for sales."[313] Total distributions were defined as the sum of these two types.[314] The first option implies that it was possible to make Distributions via the cash management system, as SHP claims.

2. The Parties' Course Of Performance Shows That SHP Was Making Distributions Through The Cash Management System

Because the contract is unclear as to how Distributions were to be made, it is appropriate to look at the parties' course of dealing as evidence of how the parties intended the contract to be interpreted.[315] I find that the parties, through their course of performance of the contract, understood that Distributions could be made to CalPERS through the cash management system.[316] SHP agreed with CalPERS, in writing, that CalPERS would fund *all* of the Fund's ongoing cash requirements—including SHP's 4.58% share—through its cash management system.[317] SHP would account for this cash from CalPERS on its monthly financial statements, and would account for its 4.58% share of any contribution that CalPERS had made under a line entry labeled "Due to" CalPERS. When the Fund returned cash to the members, SHP's share of the cash would first be offset against the "Due to" CalPERS entry. If SHP's share of the cash exceeded the "Due to" CalPERS amount, the surplus would be marked as being "Due from" CalPERS.

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[313] JX 93 app. 420-B (CalPERS Cash Management Policies & Procedures Manual (July 2003)).
[314] *Id.*
[315] *E.g.*, *Eagle Indus. Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1232 (Del. 1997).
[316] *See* Restatement (Second) of Contracts § 202(4) (1981) ("Where an agreement involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement.").
[317] JX 78 (email from Christiana Wilson to Andre Maksimow (Mar. 19, 2003)).

Over the course of its management of the Fund, CalPERS contributed approximately $34 million to the Fund toward the operating requirements of the Projects in this way. And, the Fund paid several millions back to CalPERS. But, CalPERS denies that it allowed SHP to treat cash flows to CalPERS through the cash management system as "Distributions" for the purpose of the Incentive Distribution. In support of this claim, CalPERS points to correspondence between CalPERS and SHP during SHP's management of the Fund. In July 2003, Mike McCook, a senior investment official at CalPERS, sent an email to SHP and other CalPERS partners, which stated:

> Company funds swept to or held by CalPERS at State Street Bank shall be held for the benefit of the Company. On a monthly basis, the Manager shall request that CalPERS remit to the Manager its portion of the cash available for distribution. CalPERS shall credit the Manager monthly with interest on the amount so remitted to the Manager at the same interest rate earned by CalPERS on funds invested at State Street Bank. All amounts in Company accounts at Bank of America, as well as amounts held by CalPERS at State Street Bank, shall be and remain the property of the Company.[318]

The final sentence of the email is consistent with the LLC Agreement and the Cash Management Manual, which provide that cash in the cash management system remain the property of the Fund.[319] At SHP, Maksimow recognized that this approach to the cash management system was inconsistent with SHP's approach to accounting. Maksimow wrote to Anderson that, if the money in the cash management system was considered the property of the Fund, then SHP would have miscalculated its Incentive

[318] JX 97 (email from Mike McCook to CalPERS partners (July 16, 2003)).
[319] LLC Agreement § 7.6; JX 93 § 140.

Distribution.[320] As Maksimow put it, "[t]his could be an extremely bad outcome" for SHP.[321]

CalPERS points out that SHP never responded to CalPERS to request a clarification of how it was to adapt the "Due to/Due from" mechanism to CalPERS' cash management system.[322] In 2005, SHP took up this issue again with CalPERS, and asked Katherine Fox to confirm that cash held in the cash management system was the property of CalPERS.[323] Fox replied to Maksimow that "[a]ll revenues collected through Company level bank accounts are property of the Company and are held as such. At no point are the funds the sole property of CalPERS."[324] Maksimow informed Fox that he was asking the questions on behalf of the Fund's auditor, KPMG. But, KPMG's audit employee testified at her deposition that SHP never informed KPMG of CalPERS' answer, and Maksimow never replied to Fox to say that CalPERS' policy was inconsistent with SHP's approach.[325]

SHP's failure to resolve this issue explicitly with CalPERS is disquieting, but is not fatal to its claim. Starting in 2004, SHP made clear in its quarterly management reports that it was accounting for payments of cash to CalPERS through the cash management system as "Distributions," as well as in its monthly cash flow statements, all

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[320] JX 102 (email from Andre Maksimow to Craig Anderson (July 16, 2003)).
[321] *Id.*
[322] Tr. 343:13-16 (Maksimow).
[323] JX 352 (email from Andre Maksimow to Katherine Fox (Oct. 31, 2005)).
[324] *Id.*
[325] Jackson Dep. 309:7-10; Tr. 346:20-22 (Maksimow – Cross).

of which CalPERS reviewed.[326] Because the monthly financial statements contained a specific line item for the Incentive Distribution owed to SHP, CalPERS saw—every month—and understood the precise effect of such an accounting policy on the payments due to SHP.[327] CalPERS did not object to this accounting treatment.[328] In fact, CalPERS went so far as to *confirm* this treatment of Distributions in writing when it was asked to do so by the Fund's auditor, KPMG.[329] CalPERS also requested an independent accounting firm, Mayer Hoffman McCann, to verify the "incentive fee data input."[330] Mayer Hoffman found no exceptions.[331] CalPERS never paid the Fund any interest on the money in the cash management system, further undermining the notion that the parties treated the money in the cash management system as the property of the Fund.[332]

Importantly, SHP's accounting system gave effect to the intent of the parties, in that it reflected the economic reality of the cash flows between the parties for the purpose

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[326] *See, e.g.*, JX 204, at 17 (SHP Quarterly Report, Q3 2004) ("The Company meets its daily cash requirements from capital contributions supplied by CalPERS. All cash distributed to CalPERS pursuant to this cash management system, is recorded as a distribution of capital, and all cash contributed to the Company is recorded as a contribution of capital.").

[327] *E.g.*, JX 212, at 3 (December 2004 monthly balance sheet) (listing $109,730 as due from SHP to CalPERS).

[328] At trial, Pottle denied reviewing the monthly and quarterly financial statements. He admitted, however, that they would have been reviewed by one of his subordinates, likely Grijalva. Tr. 504:16-21, 508:11-14. The court does not accept CalPERS' suggestion that, for almost six years, it was unaware of how its partner was accounting for cash flows on the Fund's financial statements.

[329] *See* JX 893 (email from KPMG to SHP (Sept. 22, 2008)).

[330] JX 786 (email from Mike Gutierrez, Mayer Hoffman McCann, to Katherine Fox (July 17, 2008)).

[331] JX 817 (Mayer Hoffman McCann report (Aug. 11, 2008)).

[332] Tr. 360:18-21 (Maksimow).

of calculating the Incentive Distribution.[333] CalPERS had sole control over the funds in the cash management system; when SHP transferred cash to the cash management system, the Fund lost control over it.[334] SHP's accounting expert, Marc Sherman, testified that from an accounting perspective, the Fund could not be considered the "owner" of the funds in the cash management system if it had no control over them.[335] Therefore, I conclude that CalPERS must calculate an Incentive Distribution based on SHP's treatment of cash flows.

D. <u>The Hurdle Rates</u>

The parties dispute which hurdle rates must be used under the LLC Agreement to calculate the Incentive Distribution. The LLC Agreement provides different hurdle rates for Independent Living Projects and CCRC Projects.[336] Independent Living hurdle rates are lower than CCRC hurdle rates.[337] SHP argues that there are six Projects in total, and that the Independent Living hurdle rates should be applied to the three residential Projects, and the CCRC hurdle rates should be applied to the three healthcare facilities. CalPERS argues that the Projects consist of three CCRCs, each including a residential facility and a healthcare facility. Neither party argues that the question of how to define the Projects for the Incentive Distribution was left to the discretion of the appraisers. Rather, they both take the position that it is a matter of contractual interpretation that this

[333] *See Paul v. Deloitte & Touche*, 974 A.2d 140, 145 (Del. 2009) ("In analyzing disputes over the language of a contract, we give priority to the intention of the parties."). This principle is even enumerated in the LLC Agreement: "The provisions of this Agreement shall be interpreted in a reasonable manner to effect the purpose of the parties." LLC Agreement § 9.18.
[334] Tr. 296:8-16 (Maksimow).
[335] Tr. 1079:22-1081:8 (Sherman).
[336] *Id.* Ex. H § 4.
[337] *Id.*

court must resolve. It is a comparatively minor issue, with only $400,000 riding on the outcome.[338]

Neither side is entirely right. An Independent Living Project is defined in the LLC Agreement as "a Project that includes multi-unit residential facilities for senior citizens where most residents receive supportive hospitality services such as meals, housekeeping, transportation and social programs, as well as not more than minimal assistance with daily living activities . . . ."[339] A CCRC is defined as "a Project with multi-unit residential communities for senior citizens that are comprised of independent living units, assisted living units and units designed for providing skilled nursing care . . . ."[340] CalPERS is correct that the healthcare facilities, on their own, cannot be described as CCRCs, and Anderson admitted this at trial.[341] But, each independent living facility with its attached healthcare facility does meet the definition of CCRCs, because it contains a mix of independent living and nursing units, and SHP's own expert testified to this effect.[342]

But, it is not correct to class the independent living facilities as CCRCs for the period before the Fund acquired the healthcare facilities. This is because during that time there was no mix of unit types, as is necessary for a property to be considered a CCRC under the LLC Agreement. During that time, the Projects should be considered three

338 Pls.' Post-Tr. Ans. Br. 44-45.
339 LLC Agreement § 1.1.
340 *Id.*
341 Tr. 93:11-16 (Anderson – Cross).
342 Tr. 1100:5-1102:12 (Passero – Cross).

Independent Living Projects. Pottle in fact acknowledged the logic of this approach in an email to Anderson in November 2008, when he wrote:

> If there was a short period of a year or so while the properties owned were IL only, the calculation may use the IL hurdles for that time and use the CCRC hurdles starting when the [assisted living] and [skilled nursing] facilities were acquired . . . . In any case, the Incentive Distribution must use the CCRC hurdle rates for the appropriate period of time.[343]

Thus, CalPERS must pay the Incentive Distribution to SHP based on the Independent Living hurdle rates for the time until the Fund acquired the healthcare facilities, and then must use the CCRC hurdle rates.[344]

*   *   *

In sum, the Incentive Distribution is to be calculated (1) using the appraised values in the Original Duff & Phelps Appraisals; (2) treating returns of cash to CalPERS through the cash management system as "Distributions"; and (3) applying the Independent Living hurdle rates for the period that before the Fund acquired the healthcare facilities, and the CCRC hurdle rates thereafter.

VI. <u>The Membership Interests</u>

I now move to SHP's claim that CalPERS owes it payment for its Membership Interests. The LLC Agreement required CalPERS to purchase SHP's and SHC's 4.58% Membership Interests when they withdrew from the Fund. The parties disagree on both

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[343] JX 977 (email from Randy Pottle to Craig Anderson (Nov. 7, 2008)); *see also* JX 1058 (email from Fred Minnes to Randy Pottle (Nov. 26, 2008)) ("CalPERS has taken the position that the entire portfolio is CCRC, with the possible exception of the initial cash flows when the Fund owned only the IL.").

[344] I note that SHP also suggested this as an option in its briefing. Pls.' Post-Tr. Ans. Br. 45.

how to value SHP's and SHC's Membership Interests, and when precisely these Membership Interests should be valued.

A. <u>The Valuation Of The Membership Interests</u>

SHP withdrew from the Fund on December 8, 2008, at which point CalPERS was required to buy out its (and SHC's) Membership Interests.[345] SHP gave notice of its intent to withdraw on June 12, 2008.[346] Under Section 5.1(a) of the LLC Agreement, CalPERS was required to have the Projects appraised to determine their value 120 days after SHP gave notice of its intent to resign, *i.e.*, as of October 9, 2008.[347]

CalPERS had the Projects appraised as of October 9, 2008, by Cushman & Wakefield, another firm from its spring-fed pool of approved appraisers. SHP argues that these appraisals must be used to determine the Fund's value as of that date. SHP also argues that this court should adjust the appraised values because CalPERS improperly forced Cushman & Wakefield to lower them before the appraisals were issued.[348]

CalPERS' theory of the Membership Interests has changed along with its theory of accounting for the residents' liabilities. CalPERS' initial approach was to try to get the lowest possible appraised value of the Projects. CalPERS did this in two ways. First, before Cushman & Wakefield sent the draft appraisals to SHP, Pottle at CalPERS spoke with Cushman & Wakefield and persuaded Cushman & Wakefield to increase the

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[345] LLC Agreement § 5.1(a).
[346] JX 755 (letter from Craig Anderson to Ted Eliopoulos (June 12, 2008)).
[347] LLC Agreement § 5.1(a).
[348] Pls.' Post-Tr. Op. Br. 10.

discount rate from 11.5% to 13%.[349] This change reduced the value of the Projects by $18 million, thereby wiping over $800,000 off the value of SHP and SHC's Membership Interests, but Cushman & Wakefield did not provide any reason for the change.[350] Second, CalPERS instructed Cushman & Wakefield to issue the reports after taking into account a "hypothetical condition," under which $34 million, representing the value of supposed shortfalls in the Fund's cash flows over the previous three years, was deducted from the Projects' value.[351]

After SHP objected to Cushman & Wakefield's appraisals, CalPERS triggered the LLC Agreement's Appraisal Arbitration Process, and ordered new appraisals from CBRE. Pottle again pressured CBRE to deliver very low values, and the managing director of CBRE accused Pottle of "meddling" in the valuation process, with "no data to support his arguments."[352] After CBRE valued the Projects at more than 5% less than Cushman & Wakefield, CalPERS ordered a third set of appraisals from Colliers. Pottle pressured Colliers to deliver a low value, but even CalPERS admits that these appraisals are not USPAP-compliant.[353]

CalPERS' invocation of the Appraisal Arbitration Process was an attempt to obtain a low value for the Projects. But, in its pre-trial briefing, CalPERS abandoned its

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[349] *See, e.g.*, JX 1046, at 158-59 (Lake Port Square & Lake Harris Health Center appraisal report (Nov. 25, 2008)); JX 1072, at 158-59 (final Lake Port Square & Lake Harris Health Center appraisal report (Dec. 2, 2008)).
[350] JX 1046, at 158-59; JX 1072, at 158-59; Salzgeber Dep. 219:6-13; Dennis Dep. 193:10-194:17.
[351] JX 1101 (email from Dan Enright to Stan Dennis (Dec. 4, 2008)).
[352] JX 872 (CBRE internal email (Sept. 9, 2009)).
[353] JX 1314 (letter from Sharon O'Grady, Pillsbury, to Bob Steed, Colliers (Aug. 31, 2011)).

attempt to use the process, which both sides agree was not followed correctly.[354] Instead, CalPERS argued that, under its new double deduction theory, the Fund had no equity and thus CalPERS owed SHP nothing for its Membership Interests. After trial, CalPERS abandoned even that theory, and asked this court to apply its new "credit" theory, whereby part of the residents' liabilities is deducted from the market value of the Projects as a supposed "credit" that a buyer would demand.

As I have already discussed, I may only modify the appraisers' determinations of Fair Market Value if one party can show that there has been a breach of the implied covenant of good faith and fair dealing. I therefore start with Cushman & Wakefield's valuation of the Fair Market Value of the Projects of $176 million. I disregard the "hypothetical condition" that CalPERS instructed Cushman & Wakefield to apply to the appraised value.[355] The hypothetical condition was, as the name suggests, an entirely hypothetical condition imposed by CalPERS, and was not based on the contractually required use of judgment by Cushman & Wakefield.[356]

I must also change the discount rate that Cushman & Wakefield used in calculating the appraised values. The final Cushman & Wakefield appraised values were calculated using a discount rate of 13%. SHP suggests that I should reverse the effect of a last-second change of discount rate from 11.5% to 13%, and I agree. The record shows that Pottle improperly pressured Cushman & Wakefield in the final stages of its work to

[354] *Id.*; JX 1308 (letter from Matt Fischer, Potter Anderson, to Sharon O'Grady (May 31, 2011)).
[355] JX 1101 (email from Dan Enright to Stan Dennis, Cushman & Wakefield (Dec. 4, 2008)).
[356] *See* Salzgeber Dep. 237:24-241:9.

increase the discount rate, in a way that distorted the integrity of the appraisal process.[357] No plausible basis for this last-second move was advanced by CalPERS (such as a reasoned WACC or other methodologically sound discount rate calculation by Pottle, which Cushman & Wakefield then accepted), and the Cushman & Wakefield appraiser who made the change could not identify any specific reason for it, despite the fact that it cut almost 10% off the Projects' value.[358] Rather, it was simply a way of permitting CalPERS to benefit from a lower value for the Projects.[359] CalPERS was also concerned that Cushman & Wakefield should apply the change to the discount rate *before* issuing draft appraisals—presumably so that SHP would be unaware of any change, and CalPERS would not have to try to justify the change in the face of SHP's objections.[360] The Cushman & Wakefield director, Stan Dennis, testified that Pottle was in fact disappointed that Cushman & Wakefield did not increase the discount rate beyond 13%, and even this number provided "great angst and agitation" to him.[361]

The pressure that CalPERS applied on Cushman & Wakefield was a violation of the implied covenant of good faith and fair dealing. Therefore, I reinstate the original, unbiased discount rate of 11.5%, and the Cushman & Wakefield appraisals are to be used on this basis. Thus, CalPERS must pay SHP approximately $1,800,000 for its

[357] Dennis Dep. 189:12-196:22.
[358] Salzgeber Dep. 218:20-226:4.
[359] Pottle purported not to recall anything concerning discussions on discount rates with Cushman & Wakefield during his deposition. Pottle Dep. 342:15-344:8.
[360] JX 1034 (email from Fred Minnes to Randy Pottle (Nov. 24, 2008)).
[361] Dennis Dep. 193:1-196:22.

Membership Interests, which reflects SHP's and SHC's interests in the Fund using the value in the Cushman & Wakefield Appraisals under the 11.5% discount rate.

B. <u>The Date Payable</u>

The parties disagree on the date on which payment of the Membership Interests is to be calculated. Section 5.1(a) of the LLC Agreement, which is in the Article of the Agreement titled "Withdrawal of Manager or Member," provides that

> [u]pon the effective date of [the manager's] retirement, withdrawal or resignation, CalPERS shall pay SHP or any SHP-Affiliate all fees and reimbursements earned or accrued through such effective date in accordance with <u>Exhibit H</u>, and shall purchase the SHP Members' Membership Interests upon the same terms as described in <u>Section 4.7(c)</u> upon a Without Cause Removal Event, and the date of valuation for determining the purchase price of the SHP Members' Membership Interests shall be . . . 120 days after the date of SHP's Notification of its intent to retire, withdraw or resign.

Section 4.7(c) of the LLC Agreement, which is referred to by Section 5.1(a), provides that

> in the case of a removal of the Manager that is a result of a Without Cause Removal Event, CalPERS shall elect to purchase the Membership Interests of the SHP Members . . . on the following terms: the aggregate purchase price shall equal the amount the SHP Members would be entitled to receive upon the hypothetical liquidation of the Company (as of the effective date of termination) if the Company's assets were sold for their Fair Market Value, all Company and Project Debts paid and any remaining cash were distributed to the members . . . ; provided, further, that with respect to those Projects in which an appraisal has not been performed within four months of the effective date of the Manager's removal, CalPERS, will order an appraisal of such Projects . . . .

SHP argues that Section 5.1(a) requires that the entirety of its Membership Interests be valued as of "120 days after the date of SHP's Notification of its intent to retire," *i.e.*, October 9, 2008. CalPERS argues that Section 5.1(a) refers to Section 4.7(c), which provides that the purchase price shall be determined "as of the effective date of termination," which is December 8, 2008. CalPERS agrees that, under Section 5.1(a), the Projects needed to be appraised as of October 9, 2008, but claims that the relevant date for valuing the Fund's financial assets is December 8.

SHP has the better of the argument. Under CalPERS' approach, the phrase "date of valuation for determining the purchase price of the SHP Members' Membership Interest" would not mean what it says. Rather, it would be the date of valuation of *part* of the purchase price of the Membership Interests, and would not "determine" the price of the Membership Interests.[362] Furthermore, Section 5.1(a) uses the word "valuation," not "appraisal." "Valuation" is used in the LLC Agreement in a more general sense than "appraisal," and covers all kinds of assets, whereas "appraisal" refers to only the valuation of the Projects.[363] If the parties had intended to refer only to an appraisal of the Projects 120 days after SHP's withdrawal, they could have used this word, just as they did elsewhere in the LLC Agreement.[364]

As against this, CalPERS argues that the manager would be able to dissipate assets and incur new liabilities "with impunity" in the 60 days between the appraisal of the

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[362] *See, e.g.*, *Determine*, Merriam Webster, http://www.merriam-webster.com/dictionary /determine (last visited May 13, 2013) (defining "determine" as "to fix conclusively or authoritatively").
[363] *See, e.g.*, LLC Agreement § 9.14 ("Appraisal. In the course of the administration of its assets, and at its own expense, CalPERS shall have the right, upon reasonable prior notice to the Manager, to have an independent appraiser selected by CalPERS annually *appraise* the Projects of the Company to determine their Fair Market Value. Any such *appraisal* shall be made subject to the procedures described in the definition of Fair Market Value in Article I of this Agreement. *Valuation of all of the other assets of the Company* may be performed when and as required under generally accepted industry standards.") (emphasis added).
[364] *E.g.*, LLC Agreement § 4.7(c).

Projects and the final date of valuation of the Membership Interests.[365] This seems unlikely, given that—as CalPERS has pointed out—the manager owes a fiduciary duty to CalPERS, and would be liable to CalPERS for any such faithless acts. Therefore, I find in favor of SHP on the question of the payment date.

VII. The Asset Management Fees

The LLC Agreement provides that, on a quarterly basis, CalPERS must pay SHP an Asset Management Fee "for managing the Company's interest in the Projects."[366] This Asset Management Fee is a percentage of the Fair Market Value of the Projects.[367] SHP claims that CalPERS has wrongly refused to pay it its Fees due for the period between October 1, 2008, and December 8, 2008. SHP has based its claim for an Asset Management Fee for this period on the Fair Market Value of the Original Duff & Phelps Appraisals.

CalPERS disputes SHP's claim, for two reasons. First, it claims the Original Duff & Phelps Appraisals are not reliable, and should not be used to calculate the Asset Management Fees. Second, it claims that SHP is erroneously including the leasehold interest of the Projects in the determination of Fair Market Value for purposes of the calculation of the Asset Management Fees. Relatedly, CalPERS is trying to reclaim from SHP an alleged overpayment of Asset Management Fees for the period between October 1, 2007, and September 30, 2008, for these two reasons.

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[365] Defs.' Pre-Tr. Ans. Br. 6.
[366] LLC Agreement Ex. H § 2.
[367] *Id.*

For the reasons I have discussed, I reject CalPERS' attempt to have me replace the Original Duff & Phelps Appraisals. I thus move on to CalPERS' claim that the leasehold interest should not be included in the determination of Fair Market Value for purposes of the calculation of the Asset Management Fees. CalPERS did not make this claim in its answer to SHP's complaint or its counterclaims, and adopted this position for the first time in its pre-trial briefing. CalPERS argues that the contractual formula that governs the LLC Agreement provides that the "Company's interest" in the Projects shall be used as the basis of the Asset Management Fees calculation. CalPERS claims that because the Fund does not own the leasehold interest, the leasehold interest should not be included in the determination of Fair Market Value for the Asset Management Fees.

The LLC Agreement is silent on this matter, and so it is necessary to look to extrinsic evidence to determine the parties' intent.[368] The best extrinsic evidence is what the parties actually did.[369] CalPERS paid SHP Asset Management Fees for five years based on a Fair Market Value that included the leasehold interest.[370] When, in September 2008, SHP submitted the final request for Asset Management Fees that was paid, Pottle specifically approved the requested Fee based on the Original Duff & Phelps Appraisals, including the leasehold interest.[371] Someone at CalPERS—and I find that this was likely Pottle—wrote on the cash flow form: "CONCUR WITH FEE DUE. CALCULATION

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[368] *See, e.g.*, *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1232 (Del. 1997).
[369] *See, e.g.*, *Julian v. Julian*, 2010 WL 1068192, at *5 (Del. Ch. Mar. 22, 2010) (citing Restatement (Second) of Contracts § 202 cmt. g (1981)).
[370] *See, e.g.*, JX 520 (SHP Cash Flow Forms (Feb. 2007)).
[371] JX 881 (CalPERS real estate cash flow form (Sept. 15, 2008)).

CONSISTENT WITH APPROVED METHODOLOGY & PRACTICE."[372] Thus, I am not going to deviate from the established course of dealing between the parties by permitting CalPERS to exclude the leasehold interest from the Fair Market Value that is used to calculate the Asset Management Fees.

VIII. The Severance Compensation

SHP and CalPERS dispute whether CalPERS is responsible for paying SHP $1.2 million in Severance Compensation under the Management Agreements. The Management Agreements govern the relationship between the Project "Owners," the limited liability companies through which CalPERS owned the Projects, and the Project "Managers," SHP's two affiliated companies which it installed to manage the Projects after the former managers resigned in 2005.[373] The Management Agreements provide that

> a sale, exchange, or other transfer of the [Project] by Owner, a sale, exchange, or other transfer of at least 50% of the membership interest in Owner, or a change in the manager of the Fund (such that SHP Asset Management, LLC is no longer the manager of the Fund) shall constitute a termination of this Agreement by Owner, without cause, entitling Manager to [Severance Compensation].[374]

CalPERS concedes that, under a literal plain reading of this language, SHP is owed Severance Compensation, because SHP ceased to be the manager of the Fund.[375] But, CalPERS argues that this provision was not designed to cover a situation whereby SHP chose to resign from the Fund, was by choice not a Manager of the Fund, and thus

[372] *Id.*
[373] *See* JX 198 (letter from Neil Ezell to Craig Anderson (Oct. 12, 2004)).
[374] IL Management Agreements § 3.02(D); HC Management Agreements § 3.02(D).
[375] Defs.' Post-Tr. Op. Br. 57-58.

itself triggered a payout to its affiliates. If SHP received money for resigning, CalPERS says, it would be able to reap a windfall. Rather, CalPERS argues that SHP negotiated this language so that, if CalPERS terminated SHP as the Fund manager, SHP would not need to continue running its captive companies as the Managers of the Projects. This position is intuitively sensible, because SHP's strengths as a partner for CalPERS lay in SHP's ability to realize value from investing in Projects, not in managing them.[376] As a remedy for this supposed drafting error, CalPERS asks me to reform the Management Agreements under the doctrines of mutual or unilateral mistake, to provide that SHP is not entitled to Severance Compensation simply because SHP has chosen to resign as the Fund manager.[377]

I reject CalPERS' argument, although it has equitable force. A party that seeks to reform a contract "must show by clear and convincing evidence that the parties came to a specific prior understanding that differed materially from the written agreement."[378] This is a heavier burden than the "preponderance of the evidence" standard, and CalPERS has not met it.[379] As CalPERS concedes, the plain language of the contract governs.[380] There is no ambiguity requiring interpretation.[381] And, even if there were, CalPERS has offered no persuasive bargaining history showing that the language implicitly did not apply to a situation where SHP resigned. CalPERS declined to call as a witness at trial the

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[376] *See, e.g.*, JX 17, at 2 (memorandum to members of CalPERS Investment Committee (Oct. 16, 2000)).
[377] *E.g.*, V. Countercls. ¶¶ 157-59.
[378] *Cerberus Int'l, Ltd. v. Apollo Mgmt., L.P.*, 794 A.2d 1141, 1151-52 (Del. 2002).
[379] *Id.* at 1151.
[380] *See E.I. du Pont de Nemours & Co. v. Allstate Ins. Co.*, 693 A.2d 1059, 1061 (Del. 1997).
[381] *Id.*

CalPERS employee, Judy Alexander, who negotiated the Agreements, despite naming her as a potential witness in the pre-trial stipulation.[382] Thus, no CalPERS' employee testified to what the parties did intend when they negotiated the Management Agreements, and this undercuts CalPERS' argument.[383] Anderson, on the other hand, testified that he negotiated the Severance Compensation in the event that SHP quit voluntarily in order to cover the captive operators' start-up and wind-down costs.[384] Although I am not certain that the Management Agreements were meant to cover the event of SHP quitting voluntarily, because of the plain language of the contract, the high burden that applies to reformation claims, and CalPERS' failure to supply any testimony to rebut Anderson, CalPERS must pay the Severance Compensation.

IX. CalPERS' Counterclaims

In its counterclaim, CalPERS sought declaratory and injunctive relief under the LLC Agreement, on the ground that SHP was not entitled to an Incentive Distribution from CalPERS, that the appraised values that resulted from the Appraisal Arbitration Process should be used to determine the value of the Membership Interests, and that SHP should refund Asset Management Fees to CalPERS.[385] CalPERS claimed that the LLC Agreement requires SHP to provide replacement audited financials for 2007 and hand over the Fund's books and records, and that SHP breached the LLC Agreement's implied

[382] Pre-Tr. Stip. 12.

[383] "It is a well established principle that the production of weak evidence when strong is, or should have been, available can lead only to the conclusion that the strong would have been adverse." *Smith v. Van Gorkom*, 488 A.2d 858, 878 (Del. 1985).

[384] JX 327 (draft Management Agreement (July 20, 2005)) (providing for no payment of Severance Compensation in the event that SHP quit voluntarily); Tr. 61:5-22 (Anderson).

[385] V. Countercls. ¶¶ 121-27.

covenant of good faith and fair dealing.[386] CalPERS alleged that SHP breached its fiduciary duties to CalPERS and the Fund by, among other things, withdrawing $33.9 million from the cash management system, and causing CalPERS to enter into Management Agreements under which CalPERS would be obliged to pay Severance Compensation if SHP withdrew as manager of the Fund.[387] CalPERS sought to reform all these Management Agreements.[388] And, as part of its remedy for its contractual and fiduciary claims, CalPERS sought an accounting.[389]

CalPERS abandoned many of its claims at trial, such as its demand that I use the results of the Appraisal Arbitration Process to determine the value of its Membership Interests, and that it should receive books and records and new audited financial statements at trial and in its post-trial briefing. I need not spend time on CalPERS' remaining contractual counterclaims, because I have resolved the contract dispute against CalPERS. For the reasons I have explained, I do not grant CalPERS reformation of the Management Agreements.

And, I find that SHP has not breached the implied covenant of good faith and fair dealing under the LLC Agreement. As our Supreme Court has noted, this doctrine requires "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract

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[386] *Id.* ¶¶ 128, 148-52.
[387] *Id.* ¶¶ 131-41.
[388] *Id.* ¶¶ 157-59, 171-73, 185-87, 199-201, 213-15, 227-29.
[389] *Id.* ¶¶ 153-56.

from receiving the fruits of the bargain."[390] I do not find that SHP has acted arbitrarily or unreasonably in ensuring that it obtained the benefit of its bargain under the LLC Agreement. Nor do I find that SHP provided the appraisers with any information in bad faith. Indeed, SHP had little or no influence over much of the payout it was entitled to receive under the LLC Agreement, because the appraisals of the Projects were carried out by independent firms selected by CalPERS, and CalPERS told the appraisers not to rely on SHP.

As to SHP's alleged breaches of fiduciary duty, these fail along with CalPERS' contractual claims. In any event, all of these alleged breaches arise out of the same facts as SHP's alleged breaches of contract. As the Supreme Court has held, "where a dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim," and "any fiduciary claims arising out of the same facts that underlie the contract obligations [are] foreclosed as superfluous."[391] I thus rule against CalPERS on all its counterclaims.

X. Pre-Judgment Interest And Costs

A. Pre-Judgment Interest

SHP has submitted an expert report on an appropriate rate of pre-judgment interest. SHP's expert, Robert Harvey, examined how CalPERS' asset classes had performed between December 8, 2008, when payment was due to SHP, and June 30,

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[390] *Nemec v. Shrader*, 991 A. 2d 1120, 1129 (Del. 2010) (quotation omitted).
[391] *Id.*

2012.[392] Harvey then estimated, based on CalPERS' asset allocation strategy, how much CalPERS would likely have earned by withholding SHP's money. Finally, Harvey estimated the opportunity cost the plaintiffs had suffered by not being able to invest the money themselves.

Harvey's report is speculative, and depends on many uncertain inputs about what each of the parties may have done in very volatile investment markets. I am not comfortable embracing it. Therefore, I do not attempt to determine an appropriate interest rate on my own, but instead grant the default rate of pre-judgment interest that our General Assembly has laid down, compounded quarterly, at a fixed rate from December 8, 2008, when the payments to SHP were due.[393]

B. Attorneys' Fees And Costs

SHP argues that it is entitled to its attorneys' fees and costs. The LLC Agreement provides that, in the event of litigation between the parties, the party "prevailing" in that litigation shall be entitled to its "reasonable attorneys' fees and court costs."[394] The "traditional application" of the prevailing party standard is an "all-or-nothing approach involving an inquiry into which party predominated in the litigation."[395] SHP has predominated in its claims under the LLC Agreement, winning on all of its arguments with the exception of a small issue related to the hurdle rates.

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[392] *See* Harvey Report 5.
[393] 6 *Del. C.* § 2301(a); *see Brandin v. Gottlieb*, 2000 WL 1005954, at *28-29 (Del. Ch. July 13, 2000) (Court of Chancery has discretion to determine the rate of prejudgment interest and decide between simple and compound interest).
[394] LLC Agreement § 9.2.
[395] *Comrie v. Enterasys Networks, Inc.*, 2004 WL 936505, at *2 (Del. Ch. Apr. 27, 2004).

The Management Agreements, which govern SHP's claims for Severance Compensation, do not have a separate fee-shifting provision. Instead, SHP claims that it is entitled to its attorneys' fees and costs as to its claim for Severance Compensation based on the indemnification provision in the Management Agreements. Under this provision, the Project owners promised to "indemnify Manager . . . from, and defend [it] and hold [it] harmless against, any and all Damages arising out of or resulting from . . . Owner's breach of any of its obligations under this Agreement."[396] Separately, SHP claims that it is entitled to its fees under the bad faith exception to the American Rule.

In its briefing, CalPERS noted that the LLC Agreement contained a fee-shifting provision, but argued that SHP's request for fees was premature, and denied that it had acted in bad faith. CalPERS did not specifically deal with SHP's request for fee-shifting under the Management Agreements. Therefore, I must address this issue without responsive briefing. SHP's attempt to turn the indemnification provision into a fee-shifting provision is odd. Although there does not appear to be any case law from this court on the subject, our Superior Court has recently surveyed the practice of courts around the country, and found that there is a split among state and federal courts on whether indemnification provisions can be used as fee-shifting provisions.[397] The Superior Court then followed the side with the slight weight of authority on the issue, holding that "indemnity agreements are presumed *not* to require reimbursement for attorneys' fees incurred as a result of substantive litigation between the parties to the

[396] IL Management Agreements § 7.01(B); HC Management Agreements § 7.01(B).
[397] *TranSched Sys. Ltd. v. Versyss Transit Solutions, LLC*, 2012 WL 1415466, at *1-2 (Del. Super. Ct. Mar. 29, 2012).

agreement absent a clear and unequivocal articulation of that intent."[398] The logic for this holding is that otherwise an indemnification provision would swallow the American Rule that parties are usually responsible for their own costs. This court has recently applied New York law to construe an indemnification provision so as to exclude attorneys' fees on the ground that "a party seeking indemnification for first-party claims must be able to point to specific language that is applicable to such claims."[399]

Here, there is no specific language in the indemnification provision of the Management Agreements that covers fee-shifting. Therefore, I will not interpret the provision in an expansive way that would be inconsistent with the American Rule. SHP's backup argument as to the payment of attorneys' fees is that CalPERS should be required to pay attorneys' fees under the bad faith exception to the American rule. I find that, in its refusal to pay Severance Compensation, CalPERS has taken a position that, although at odds with the plain language of the Management Agreements, has not been faithless. CalPERS gave a non-frivolous reason why it would not pay the Severance Compensation at the end of 2008, and has consistently stuck to it.[400] Therefore, as to this small aspect of the dispute between the parties, I do not award SHP its costs. SHP is still entitled to receive its costs for all of the claims on which it has succeeded under the LLC Agreement.

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[398] *Id.* at *2.

[399] *Bear Stearns Mortg. Funding Trust 2007-AR2 v. EMC Mortg. LLC*, 2013 WL 164098, at *2 (Del. Ch. Jan. 17, 2013).

[400] *See* JX 1060 (letter from Fred Minnes to Morris Miller, Holland & Knight LLP (Nov. 26, 2008)).

XI. Conclusion

I now summarize in rough form the results of my resolution of the parties' claims. As to SHP's first, second, third, and fourth[401] causes of action, which relate to the LLC Agreement, I rule that:

- CalPERS must pay SHP an Incentive Distribution based on the Original Duff & Phelps Appraisals and SHP's accounting of Distributions via the cash management system. The hurdle rates are to be for the Independent Living Projects for the period when the Fund only owned the Independent Living Projects, and are to be for CCRCs thereafter.
- CalPERS must pay SHP for its Membership Interests based on the Cushman & Wakefield appraisals, without the hypothetical condition, with the discount rate restored to Cushman & Wakefield's original, unbiased rate of 11.5%. The valuation date for the Membership Interests is October 9, 2008.
- CalPERS must pay SHP an Asset Management Fee for the period between October 1, 2008, and December 8, 2008, based on the Original Duff & Phelps Appraisals.
- Offset from these sums is the $1.7 million that SHP acknowledges that it owes to CalPERS.

[401] The fourth cause of action is a claim for a breach of the implied covenant of good faith and fair dealing. SHP has proven a breach of the implied covenant in the manipulation of the discount rate that Cushman & Wakefield used in its appraisals.

As to SHP's fifth to tenth causes of action, which relate to a breach of the six Management Agreements, I rule that CalPERS must pay SHP Severance Compensation under all the Agreements.

SHP is entitled to pre-judgment interest, compounded quarterly, at the statutory rate. SHP is also entitled to all its attorneys' fees and costs, with the exception of those that relate to its claim for Severance Compensation.

I find against CalPERS on all of its counterclaims.

The parties shall confer with their economic experts, calculate the resulting numbers, and prepare an implementing final judgment order. That order shall be submitted by SHP within ten days, after approval as to form by CalPERS.