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14 UNITED STATES BANKRUPTCY COURT  
 15 EASTERN DISTRICT OF CALIFORNIA  
 16 SACRAMENTO DIVISION

18 In re:  
 19 CITY OF STOCKTON, CALIFORNIA,  
 20 Debtor.

Case No. 12-32118  
 Chapter 9  
 Adv. No. 13-02315

21 WELLS FARGO BANK, NATIONAL  
 22 ASSOCIATION, FRANKLIN HIGH  
 23 YIELD TAX-FREE INCOME FUND,  
 24 AND FRANKLIN CALIFORNIA  
 HIGH YIELD MUNICIPAL FUND,

Plaintiffs,

v.

26 CITY OF STOCKTON, CALIFORNIA,  
 27 Defendant.

**CITY OF STOCKTON'S PRE-TRIAL  
 REPLY BRIEF**

Date: May 12, 2014  
 Time: 9:30 a.m.  
 Dept: Courtroom 35  
 Judge: Hon. Christopher Klein

1 **I. INTRODUCTION**

2 On March 27, 2014, the City made a bold move in this case. Agreeing to lay down its  
3 arms, it filed a motion in which it offered the plaintiffs what they had been requesting for months:  
4 recharacterization of the lease/lease back transaction as a secured loan transaction. The City's  
5 goal was to stop wasting valuable time and resources on litigating the adversary proceeding so  
6 that the parties could focus on the main event: confirmation of the Plan.<sup>1</sup> Speedy confirmation  
7 will resolve the claims of the hundreds of creditors who have reached agreements with the City,  
8 and it will allow the City's management team to focus its energies on building a more prosperous  
9 and secure future for its residents.

10 Now that the Partial Judgment has been entered, the claims for relief in the plaintiffs'  
11 complaint will shrink from five to three, and the scope of the issues to be adjudicated during the  
12 trial will be considerably narrowed, just as the City envisioned.<sup>2</sup>

13 Franklin has incurred over \$200,000 for appraisal testimony in an attempt to construct a  
14 suspect and seriously flawed valuation argument that the collateral that secures the loan claim—a  
15 24 or 34 year possessory interest in two golf courses and a park that have run operating deficits  
16 every year during recent memory—has a positive value. In reality, Franklin's collateral has no  
17 value at all. Thus, Franklin's "secured" claim is in the amount of zero dollars.

18 **II. PROCEDURAL BACKGROUND**

19 The City submits this reply brief pursuant to paragraph 12 of the Modified Scheduling  
20 Order [Dkt. No. 1242]. On April 7, 2014, the City filed its opening brief [Adv. Dkt. 49] (the  
21 "City's Opening Brief"), which includes a brief summary of the procedural background prior to  
22 that date, and Franklin filed its opening brief [Adv. Dkt. No. 47] ("Franklin's Opening Brief").  
23

24 <sup>1</sup> Due to the multitude of pleadings already filed in this case, the City is again defining terms with which the Court is  
25 very familiar. Any capitalized term used but not defined herein shall have the meaning ascribed to it in the First  
26 Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1204]  
27 (the "Plan") or in the City's Opening Brief [Adv. Dkt. 49] (defined below).

28 <sup>2</sup> The parties have briefed in their Opening Briefs the issue of the allowability of the recharacterized secured loan  
claim now held by Franklin after entry today of the Partial Judgment and the City will not repeat those arguments  
here. The City points out however, that as a secured loan transaction, the City received all of the benefit of the loan  
at inception when the Financing Authority received the \$35 million in bond proceeds. Franklin has failed to explain  
to the Court how Franklin provides the City with new value during each succeeding year so as to comply with the  
*Offner-Dean* line of cases. The City reserves all rights with respect to the allowability issue.

1 Also on April 7<sup>th</sup>, a status conference was held and continued to May 1<sup>st</sup> at 1:30 p.m. Among  
 2 other things, the parties argued Defendant City of Stockton's Motion for Judgment to Be Entered  
 3 in Favor of Plaintiff [Adv. Dkt. No. 28] and agreed to upload a proposed Partial Judgment in  
 4 Favor of Plaintiffs (the "Partial Judgment"). The Court entered the Partial Judgment today, April  
 5 21st.

### 6 **III. ARGUMENT**

#### 7 **A. The Partial Judgment Dispenses with the First and Fifth Claims for Relief in** 8 **the Complaint**

9 Now that the Partial Judgment has been entered, the former Golf Course/Park Leases have  
 10 been adjudicated not to be unexpired leases or executory contracts within the meaning, scope, and  
 11 operation of sections 365 and 502(b)(6) of the Bankruptcy Code. Partial Judgment ¶¶ 1-2. Thus,  
 12 the Partial Judgment dispenses with the first claim for relief in the Complaint and dismisses with  
 13 prejudice the fifth claim for relief, in which, as an alternative form of relief, the Plaintiffs had  
 14 requested the Court to declare that they are entitled to the payment of administrative rent. Partial  
 15 Judgment ¶ 4.

#### 16 **B. If The Court Determines That the Collateral Has Any Value, a Portion of** 17 **Franklin's Claim Will Be Secured**

18 In the Plan, the City characterizes the Golf Course/Park Claims of the 2009 Golf  
 19 Course/Park Bond Trustee/Franklin as a lease rejection claim. If the Court determines at trial that  
 20 the collateral has any value, a portion of the Claim will be a secured Claim and a portion will be  
 21 an unsecured deficiency Claim. Accordingly, when the City files its modified version of the Plan,  
 22 it will add a new Class, into which the secured portion of the Claim will be classified: Class 20 –  
 23 Secured Claim of 2009 Golf Course/Park Bond Trustee/Franklin. The unsecured deficiency  
 24 Claim will remain in Class 12 – General Unsecured Claims.<sup>3</sup> Of course, if the Court determines  
 25

26 <sup>3</sup> Franklin objected to the classification of its Claim in Class 12. Summary Objection of Franklin High Yield Tax-  
 27 Free Income Fund and Franklin California High Yield Municipal Fund to Confirmation of First Amended Plan of  
 28 Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1273] § III.B.1.b). The City  
 responded to Franklin's arguments in the City's Supplemental Memorandum of Law in Support of Confirmation of  
 First Amended Plan of Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1309]  
 § III.A.2.

1 that the collateral has no value, as the City contends, the entire amount of the Claim will be  
2 classified in Class 12.

3 The parties appear to agree that the 2009 Golf Course/Park Bond Trustee's collateral for  
4 the recharacterized secured loan transaction is the right to take possession of the Golf  
5 Course/Park Properties and operate the businesses that are conducted from them for the  
6 possessory term of the former Golf Course/Park Leases. City's Opening Brief at 10, lines 22-25;  
7 Franklin's Opening Brief at 16, lines 9-11. However, the parties disagree on the length of the  
8 term. The City set forth its argument on this matter in its opening brief, and this argument need  
9 not be repeated here. City's Opening Brief at 10-11. Franklin contends that the possessory  
10 interest is perpetual. Franklin's Opening Brief at 16, line 13.

11 **C. The Collateral Has No Value**

12 Franklin has incurred over \$200,000 in appraisal services in an attempt to find a way to  
13 ascribe some value to Franklin's collateral for its secured loan transaction. Finding a way to  
14 opine that there is some value to that collateral is a mighty task given the recent economic metrics  
15 of the three subject properties:

- 16 • As acknowledged in the Chin Report, Oak Park has suffered negative operating  
17 cash flow of about \$843,000 over the past three years alone<sup>4</sup>;
- 18 • As acknowledged in the Chin Report, the Swenson golf course has suffered  
19 negative operating cash flow of \$728,328 over the past six years<sup>5</sup>;
- 20 • As acknowledged in the Chin Report, the Van Buskirk golf course has suffered  
21 negative operating cash flow of about \$1,388,600 over the past six years<sup>6</sup>.

22 Obviously, in order to determine that Franklin's collateral, which consists of the right to  
23 occupy the three properties and run the businesses and other activities on the properties for the  
24 next 24 or 34 years (or longer contends Franklin), has any value at all, an appraiser must find a  
25 way to rationalize a huge turnaround in the profitability of those businesses and activities, or to  
26 ignore the operating losses altogether. Absent one of these two approaches, one must conclude

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28 <sup>4</sup> Chin Report, page 9.

<sup>5</sup> Chin Report, page 35, including the 2013/2014 projections.

<sup>6</sup> Chin Report, page 35, including the 2013/2014 projections.

1 that the collateral has only “speculative” value – a bet that the long-running and large operating  
2 losses can be eliminated at some point in the future and the properties can begin to generate  
3 positive cash flow.

4 The Chin report embraces approaches to value that largely ignore the historical operating  
5 losses and do not consider those losses in its march to find value in the right to possession of the  
6 properties and the right to run the businesses on the properties for the next 24 or 34 years.

7 With respect to Oak Park, the Chin Report finds that there is some minimal value<sup>7</sup> in the  
8 City’s fee simple ownership of the Ice Arena located at Oak Park, but uses a sales comparison  
9 approach embodying sales of ice rinks throughout the country. This approach allows the  
10 appraiser to ignore the large operating losses incurred annually in connection with the Ice Arena,  
11 and Oak Park generally. The Chin Report similarly fails to account for the large deferred  
12 maintenance and needed capital improvements to the Ice Arena that dwarf the modest value of the  
13 City’s fee simple interest.

14 With respect to the Van Buskirk community center, a facility that is used by the City for  
15 community and civic activities that generate only incidental revenue, the Chin Report uses a  
16 replacement cost approach in valuing the City’s fee simple interest, in effect opining that the  
17 facility would sell in the marketplace for the adjusted cost of constructing the facility. This  
18 approach allows the appraiser to ignore the lack of revenues and ignore all of the operating  
19 expenses, and to ignore the resulting negative cash flow from operating the facility. The Chin  
20 Report acknowledges that the Community Center is subject to the deed restriction that the  
21 property will revert to the grantor unless used for “public recreation or public park purposes”,<sup>8</sup>  
22 but that fairly severe use limitation apparently does not factor into the valuation of the facility in  
23 any manner. By turning a blind eye to these obvious value-influencing facts, the Chin Report  
24 finds that the fair market value of the City’s fee simple interest in the Van Buskirk Community  
25 Center to be **\$2,177,193**, an amount greater than the value of the entirety of the City’s fee simple  
26  
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28 <sup>7</sup> \$400,000 – See Chin Report, page 44.

<sup>8</sup> Chin Report, page 20.

1 interest in the Swenson golf course (\$1,950,000) and more than double that of the Van Buskirk  
2 golf course itself (\$900,000)!<sup>9</sup>

3 The valuation methodology of the Chin Report to the two golf courses similarly ignores  
4 the long history of operating losses. The value of the City's fee simple interest is determined by  
5 use of a sales comparison approach and a gross income multiplier approach. The gross income  
6 multiplier approach applies a simple multiplier to the gross revenue (again without having to  
7 consider the level of operating expenses and ignoring the consistent operating losses) derived  
8 from other comparable sales of fee simple interests in golf courses. Here, however, the Chin  
9 Report relies upon a national survey of voluntarily reported gross income multipliers for golf  
10 course sales<sup>10</sup> (and does not include gross income multipliers for actual sales of golf courses in  
11 Northern California), and after establishing a range for the sale of golf courses not generating  
12 positive cash flow of .9 to 1.3X, the Chin Report goes above that range and uses a 1.4 gross  
13 income multiplier for Swenson and a 1.31 gross income multiplier for Van Buskirk.<sup>11</sup> And the  
14 Chin Report rationalizes an immediate 13.6% - 15% increase in gross revenues against which to  
15 use the gross income multipliers, a year-over-year increase in revenues that is highly unlikely and  
16 far greater than any increase in recent memory.<sup>12</sup>

17 However, the two obvious and egregious errors of the Chin Report with respect to  
18 valuation of a possessory interest in the properties are: (i) the manner in which the Chin Report  
19 instead values the City's fee simple interest (all of the above methodologies are used to calculate  
20 the value of the City's fee simple interest) and merely applies a simple discount to the City's fee  
21 simple interest to obtain the value of the possessory interest; and (ii) the failure of the Chin  
22 Report to account for necessary capital improvements and expenditures to correct deferred  
23 maintenance at the properties.

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27 <sup>9</sup> Chin Report, page 47 (\$2,177,193 fee simple value of the Community Center), and page 41 (\$1,900,000 fee simple  
value for Swenson golf course and \$900,000 fee simple value of Van Buskirk golf course).

28 <sup>10</sup> Chin Report, page 38.

<sup>11</sup> Chin Report, page 39.

<sup>12</sup> Chin Report, page 39.

1 The Chin Report merely applies a small discount to the value of the City's fee simple  
2 interest to determine the value of the possessory interest<sup>13</sup>, an approach that is attractive to  
3 Franklin in that it ignores both historical operating losses and expenditures required for capital  
4 improvements and to correct deferred maintenance. The City believes that this is an approach to  
5 valuation of a possessory interest that is not recognized in the industry and an approach that turns  
6 a blind eye to the traditional approach of a discounted cash flow (which inconveniently for  
7 Franklin, requires an analysis of the ability of the businesses to generate a positive cash flow and  
8 requires the inclusion of expenditures necessary to attempt to achieve such possible positive cash  
9 flow, including necessary capital improvements).<sup>14</sup>

10 Given his use of this unsanctioned approach to valuing a possessory interest in the  
11 properties, Mr. Chin did not bother to attempt to:

12 (i) use a sales comparison approach for the golf courses, even though he testified at his  
13 deposition that he is aware of an established market for the sale of possessory interests in golf  
14 courses;

15 (ii) evaluate or quantify any future revenue projections for Swenson, Van Buskirk or Oak  
16 Park (other than the grossly inflated golf course revenues for next fiscal year used in his gross  
17 income multiplier approach);

18 (iii) evaluate or quantify any level of expenditures for the properties or prepare any  
19 projections of the same;

20 (iv) evaluate or quantify any resulting future operating losses likely to be incurred in  
21 operating the businesses on the properties or in any way factor the same into his financial  
22 analysis;

23 (v) specifically evaluate or quantify the level of capital improvement and deferred  
24 maintenance spending necessary for Swenson, Van Buskirk or Oak Park, even though he was  
25

26 \_\_\_\_\_  
27 <sup>13</sup> The Chin Report provides no quality information as to where the actual discounts used came from and fails to  
28 quantitatively inform the reader of the justification for the size of the discount. Chin Report, page 42 (5% to 10%  
discount of City's fee simple interest for Swenson and 14% to 20% discount for Van Buskirk) and page 44 (40%  
discount of City's fee simple interest in the Ice Arena).

<sup>14</sup> The City dealt with this issue extensively in its Opening Brief and does not repeat those observations here.

1 aware of the fact that the City believed the same to be in excess of \$8 million for the golf courses  
2 alone;

3 (vi) despite his three site visits, meet with the City, or KemperSports or SMG, the  
4 managers of the golf courses and the Ice Arena, to discuss his questions about the above financial  
5 metrics or any other aspect of his valuation of the possessory interest in the properties;

6 (vi) despite his three site visits and the site visits of his staff, meet with KemperSports or  
7 any of the managers of competing golf courses to obtain any competitive pricing information  
8 other than the pricing information that is posted to the general public; or

9 (vii) meet with the City to discuss the circumstances, if any, under which the City might  
10 agree in the future to amend its general plan and change the zoning of the properties to allow  
11 residential or commercial development on the properties<sup>15</sup> as is assumed in the Chin Report.

12 For these reasons and others that will be proven at trial, the Chin Report is unreliable in  
13 the extreme in determining the right to possession of the properties and the right to operate the  
14 businesses on the properties for the next 24 or 34 years. In reality, the actual value is zero or  
15 highly speculative at best, for which the market would pay very little.

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26 <sup>15</sup> The Chin Report blithely assumes without analysis or data that the City would agree to such a change in use and  
27 zoning. See pages 11, 12 and 48. The Chin Report notes at page 48 that the existing uses in that case would be  
28 “interim uses until such time as a change of use can be achieved, and as market conditions dictate.” Thus, the higher  
land values used would be applicable only in the future, perhaps the distant future, yet the Chin Report does not  
discount this future step-up in land value to present value. The City believes, as argued in its Opening Brief, that  
there was never an intent to create a possessory interest in perpetuity, and that the City charter precludes such an  
interpretation.

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**IV. CONCLUSION**

For the reasons set forth in the City’s Opening Brief and above, the City respectfully requests the Court to dismiss Counts Two and Three of the Complaint and, with respect to Count Four, to rule that the collateral for the recharacterized secured loan transaction has no value and that therefore Franklin’s Secured Claim is in the amount of zero dollars.

Dated: April 21, 2014

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