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7 *Income Fund and Franklin California High*
8 *Yield Municipal Fund*

9 **UNITED STATES BANKRUPTCY COURT**
10 **EASTERN DISTRICT OF CALIFORNIA**
11 **SACRAMENTO DIVISION**

12 In re:
13 CITY OF STOCKTON, CALIFORNIA,
14 Debtor.

Case No. 12-32118 (CMK)
D.C. No. OHS-15
Chapter 9
Adv. Proceeding No. 13-02315-C

16 WELLS FARGO BANK, NATIONAL
ASSOCIATION, FRANKLIN HIGH
17 YIELD TAX-FREE INCOME FUND,
AND FRANKLIN CALIFORNIA HIGH
18 YIELD MUNICIPAL FUND,

19 Plaintiffs.

20 v.

21 CITY OF STOCKTON, CALIFORNIA,
22 Defendant.

FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND'S EVIDENTIARY OBJECTIONS TO DIRECT TESTIMONY DECLARATION OF RAY SMITH IN SUPPORT OF CONFIRMATION OF FIRST AMENDED PLAN FOR THE ADJUSTMENT OF DEBTS OF CITY OF STOCKTON CALIFORNIA (NOVEMBER 15, 2013)

23
24 Date: May 12, 2014
Time: 9:30 a.m.
25 Dept: C, Courtroom 35
Judge: Hon. Christopher M. Klein

1 Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal
 2 Fund (collectively, “Franklin”) respectfully submit the following evidentiary objections to the
 3 *Direct Testimony Declaration Of Ray Smith In Support Of Confirmation Of First Amended Plan*
 4 *For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013)* [Docket
 5 No. 1365 / Adv. Pro. Docket No. 60]. Franklin also incorporates by reference herein the *Motion Of*
 6 *Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund*
 7 *To Exclude Portions Of Testimony Of Ray Smith.*

PARAGRAPH OBJECTED TO	GROUNDS FOR OBJECTION
<p>8 9 10 11 12 13 14 15</p> <p>4. Following the submission of the Rebuttal Report on April 7, 2014, I continued to gather information relevant to the value of Swenson Park golf course, Van Buskirk golf course, and Oak Park. Primarily, I interviewed several persons with knowledge of these properties or with considerable knowledge of appraisal principles and practices. I also reviewed additional texts on appraisal methodology. My additional research reaffirms the conclusions in the Rebuttal Report that the Chin Report’s valuation of these properties is seriously flawed.</p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>
<p>16 17 18 19 20 21 22 23 24 25 26 27 28</p> <p>6. As I described in the Rebuttal Report, the Chin Report fails to account for nearly \$9 million in remaining necessary capital improvements and deferred maintenance at the Courses. Rebuttal Report, Ex. A (March 2010 Community Services Department Summary of Golf Course Capital Improvement Program Needs). <u>Mr. Nelson confirmed to me that without these and other improvements and maintenance, the Courses will struggle to turn a profit. Mr. Nelson provided me with an explanation of the capital improvements and deferred maintenance needed at the Courses, which include the installation of cart paths, new irrigation systems, dredging of the existing ponds that provide water for the irrigation systems, tee, bunker and greens renovation, extensive tree-trimming and landscaping, and repaving of the parking lots, among other items. The full extent of capital improvements and deferred maintenance needed at the Courses is described in detail in the Direct Testimony Declaration Of Tom Nelson Rebutting Expert Report Of Frederick E. Chin, which is being submitted concurrently. According to Mr. Nelson, the projected costs for such</u></p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i> Franklin objects to the underlined statements in this paragraph because they are inadmissible hearsay. FED. R. EVID. 801, 802.</p>

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<p>1 <u>maintenance, repair, and capital improvements</u> 2 <u>total approximately \$6 million to more than \$8</u> 3 <u>million.</u></p>	
<p>4 8. The Chin Report states that the Ice Arena 5 is the only portion of Oak Park that “contributes 6 material value to the property.” Chin Report, at 7 43. However, in addition to improperly 8 separating the valuation of the Ice Arena from 9 the value of other parts of Oak Park (and 10 treating the value of the Ice Arena as essentially 11 equivalent to the value of Oak Park), the Chin 12 Report also ignores the substantial capital 13 improvements and maintenance required at the 14 Ice Arena. <u>My conversations with Mr. Cera</u> 15 <u>revealed that such improvements and</u> 16 <u>maintenance include replacing the outdated ice</u> <u>floor, replacing leaking pipes, replacing the ice</u> <u>plant and a portion of the chillers, repairing</u> <u>chipped and damaged walls, repairing the lobby</u> <u>and restrooms, and installing a ventilation</u> <u>system in the locker rooms. The full extent of</u> <u>capital improvements and deferred maintenance</u> <u>needed at the Ice Arena is described in detail in</u> <u>the Direct Testimony Declaration Of Michael</u> <u>Cera Rebutting Expert Report Of Frederick E.</u> <u>Chin, which is being submitted concurrently.</u> <u>Mr. Cera estimated that the costs for such</u> <u>maintenance, repair, and capital improvements</u> <u>would be over \$2 million.</u></p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>. Franklin objects to the underlined statements in this paragraph because they are inadmissible hearsay. FED. R. EVID. 801, 802.</p>
<p>17 10. <u>Mr. Hopper’s analysis of the Chin Report</u> 18 <u>confirmed my own. Specifically, Mr. Hopper</u> 19 <u>concluded that the Chin Report failed to give</u> 20 <u>sufficient weight to the fact that the Courses</u> 21 <u>regularly experienced negative cash flows. Mr.</u> 22 <u>Hopper also concluded that the Chin Report</u> 23 <u>applies an inflated gross income multiplier</u> <u>(“GIM”) to an inadequately supported increase</u> <u>in gross revenue, while not properly considering</u> <u>deferred maintenance and capital improvements,</u> <u>as further discussed below. Mr. Hopper’s input</u> <u>supported my conclusions regarding the</u> <u>inadequacies of the Chin Report.</u></p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>. Franklin objects to the underlined statements in this paragraph because they are inadmissible hearsay. FED. R. EVID. 801, 802.</p>
<p>24 11. I attended Mr. Chin’s deposition on April 25 18, 2014. Mr. Chin’s deposition testimony 26 highlighted several deficiencies in the Chin 27 Report, the foremost of which are discussed 28 below.</p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>.</p>

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<p>12. Mr. Chin admitted during his deposition that he did not quantify the capital improvements needed at the Courses and Oak Park, and that his valuation is of the properties in an “as is” state (i.e., with capital improvements yet to be made). Transcript of April 18, 2014 Deposition of Frederick Chin, (<i>Rough</i>) (“Chin”), 54:15-61:02, 95:9-96:20; 97:18-98:7; 114:12- 115:7; 137:5-138:12. <u>My communications and site visits with Mr. Nelson and my communications with Mr. Cera reinforce my conclusion that the Chin Report’s failure to account for necessary maintenance and capital improvements at the Courses and Oak Park, among other considerations, renders his valuation of these properties unreliable.</u></p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>. Franklin objects to the statements in this paragraph because they misstate Mr. Chin’s testimony. Franklin further objects to the underlined statements in this paragraph because they are inadmissible hearsay. FED. R. EVID. 801, 802.</p>
<p>13. In addition to ignoring the perennial losses incurred by the Courses, Mr. Chin’s valuation gives no weight to the fact that a new owner or lessee would have to spend millions of dollars immediately and/or in the near future on necessary deferred maintenance and infrastructure, and then only with the possibility of turning around the financial performance of the Courses at some point in the future. Mr. Chin has not attempted to determine when or if any such turnaround could occur, and has not formed an opinion on whether such a turnaround would justify the expenditure of millions of dollars on deferred maintenance and capital improvements.</p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>.</p>
<p>14. Any prudent investor considering the purchase of a leasehold or fee simple interest in a property would attempt to quantify the amount of necessary maintenance, repair, and capital improvements. As an experienced investor who acknowledges in his report the importance of capital improvements, Mr. Chin should have attempted to quantify and account for these expenses in his analysis of the value of the Courses and Oak Park. Mr. Chin testified that he did not contact any personnel at either the Courses or Oak Park to inquire about this or any other issue, though he admitted during his deposition that Franklin did not instruct him not to do so.² Chin, pp. 66:6-67:13; 76:5-9.</p> <p>fn2: Mr. Chin testified in his deposition that he visited the Courses and Oak Park on three occasions but did not have any substantive discussion with KemperSports or SMG. Chin, pp. 47:05-49:14. He also testified that his</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin’s testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>.</p>

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<p>1 associates also visited the Courses to gather 2 information, but admitted that he didn't know if 3 they had any substantive discussions either. <i>Id.</i>, pp. 49:22-50:8, 51:8-54:14.</p>	
<p>4 17. Mr. Chin's deposition testimony 5 confirmed that he did not perform a discounted 6 cash flow analysis of the Courses and Oak Park. 7 Chin, pp. 126:21-127:15. The Chin Report does 8 not sufficiently explain why it does not use a cash flow analysis. A reliable appraisal must include sufficient explanation for the reader to understand why the appraisal makes the assumptions that it does.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin's testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>
<p>9 18. Mr. Chin made clear in his deposition that, 10 as a manager and equity owner of three golf 11 courses in Nevada, he evaluated all aspects of 12 cash flow, including gross revenue, cost of 13 goods sold, and operational expenses. Chin, pp. 14 19:20-21:08. He was thus fully aware of the 15 appropriate analyses of golf course investors. 16 Reflecting typical investor thinking, a careful 17 appraisal must also consider expected future 18 cash flow, which considers all components of 19 gross income, as well as the expenditures 20 necessary to generate that cash flow. Although 21 appraisers may sometimes have access only to 22 the information necessary for a GIM analysis, an actual investor contemplating the purchase of a property would demand a more thorough analysis that considers discounted cash flow. Relying solely on the GIM method, particularly one that uses only national survey data rather than local data, without performing a discounted cash flow analysis, reduces the credibility of the Chin Report's conclusions as to the market value of the fee simple interest in the Courses. This limited emphasis reflects a superficial analysis that could not be relied on without further analyses of net cash flow.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin's testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>
<p>23 19. The Chin Report does not sufficiently 24 explain its application of the GIM method. 25 Despite stating that a GIM of .9 to 1.3 is 26 appropriate for golf courses that, like Swenson, 27 have nominal or negative net margins (let alone 28 overdue maintenance and capital improvements totaling in the millions of dollars), the Chin Report uses a GIM range above that indicated, of 1.3 to 1.5 for Swenson. Chin Report, at 38- 39. Mr. Chin was unable to explain during his deposition why he used the 1.3 to 1.5 GIM range, despite the Chin Report's conclusion that</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin's testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>

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<p>1 a .9 to 1.3 range would be more appropriate, 2 other than to state that he believed that Swenson 3 had better prospects for a financial turnaround. Chin, pp. 118:16-119:19.</p>	
<p>4 20. Mr. Chin’s use of such a high GIM range 5 is particularly questionable because of the Chin 6 Report’s inflated revenue projections for the 7 Courses. The Chin Report projects an immediate 8 13%-15% increase in revenues for the Courses 9 in one year without making any capital 10 improvements or correcting deferred 11 maintenance. This is despite Mr. Chin’s acknowledgement of the market being “quite competitive” (Chin, pp. 128:23-129:11), and despite the ongoing operating losses of the Courses. Mr. Chin testified that he was not aware of the Courses ever before achieving such a year over year increase in revenues. Chin, pp. 116:15-117:22.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin’s testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>
<p>12 21. Mr. Chin testified during his deposition 13 that he is aware of an established market for the 14 sale of possessory interests in golf courses. 15 Chin, pp. 36:6-38:20. Despite this, there is no 16 discussion in the Chin Report of comparable sales of possessory interests. Nor is there an explanation of why the Chin Report does not consider such sales.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin’s testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>
<p>17 22. The Chin Report employs a methodology 18 of applying discounts to the fee simple market 19 value—a 5%-10% discount for Swenson Park, 20 and a 14%-20% discount for Van Buskirk—to 21 arrive at possessory interest market values, 22 without explaining his methodology, presenting 23 supporting data, or summarizing his analyses or 24 conclusions. At his deposition, Mr. Chin 25 testified that he used this approach because it 26 was the most appropriate one based on <i>his</i> 27 experience. Chin, pp. 104:6-107:8. When asked 28 whether such an approach to possessory interest valuation was generally recognized in the industry, Mr. Chin declared that other people are “entitled to their opinions,” and confessed not only that industry literature suggests different approaches, but also that the discounting approach “may not be a widely known or standard approach.” <i>Id.</i>, pp. 111:6-22. Partnership re-sale discount data are intended to value non-controlling fractional and tenant-in- common interests in real estate. These data are not intended for the valuation of a possessory interest in a leasehold estate.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin’s testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith.</i></p>

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<p>1 23. Mr. Chin admitted in his deposition that 2 the Chin Report did not include any functional 3 obsolescence in its valuation of the Van Buskirk 4 Community Center. Chin, pp. 97:6-17. 5 Functional obsolescence reflects impairment of 6 the functional capacity of a property according 7 to market tastes and standards. Mr. Chin's 8 analysis as to the functionality of the property 9 was inadequate. Mr. Chin also did not evaluate 10 external obsolescence, which is a diminution in 11 value involving negative characteristics outside 12 of the property, such as a rundown 13 neighborhood or recessionary economic 14 conditions. A market analysis evaluating the 15 supply and demand for community centers, in 16 the context of specific functional issues, would 17 have provided a foundation for functional and 18 external obsolescence conclusions. Comparison 19 analysis of sales of community centers would 20 also have provided that foundation. Mr. Chin 21 acknowledged he did not use comparable sales 22 in his appraisal. Chin, 99:24-100:1. Such 23 analyses are essential to determining an accurate 24 value for properties that, like the Community 25 Center, have a very limited market due to its 26 specialized use.</p>	<p>Franklin objects to the statements in this paragraph because they misstate Mr. Chin's testimony. Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax- Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>.</p>
<p>16 24. <i>Both before and after the submission of 17 the Rebuttal Report, I reviewed two 18 authoritative texts that discuss the methodology 19 of valuing a possessory or leasehold interest in 20 real property: <u>The Appraisal Process</u> by George 21 L. Schmutz, and <u>Golf Courses and Country 22 Clubs: A Guide to Appraisal, Market Analysis, 23 Development, and Financing</u>, by Arthur E. 24 Gimmy and Martin E. Benson. These texts 25 documented the importance of the discounted 26 cash flow analysis technique in the valuation of 27 leasehold interests. Also, subsequent to the 28 submission of the Rebuttal Report, I reviewed an article titled <u>Golf Courses Valuation and Evaluation</u>, by Lawrence A. Hirsh, which confirmed the importance of discounted cash flow analysis for golf course appraisals. These resources supplemented and reaffirmed the conclusions in the Rebuttal Report.</i></p>	<p>Franklin incorporates by reference herein the <i>Motion Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Exclude Portions Of Testimony Of Ray Smith</i>. Franklin objects to the italicized statements in this paragraph because they are inadmissible hearsay. FED. R. EVID. 801, 802 (underlining in the original).</p>

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Dated: April 25, 2014

JONES DAY

By: /s/ Joshua D. Morse

James O. Johnston

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