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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re:

Chapter 11

MOTORS LIQUIDATION COMPANY, f/k/a GENERAL MOTORS CORPORATION, *et al.*,

Case No. 09-50026 (MG)
(Jointly Administered)

Debtors.

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MOTORS LIQUIDATION COMPANY AVOIDANCE ACTION TRUST, by and through the Wilmington Trust Company, solely in its capacity as Trust Administrator and Trustee,

Adversary Proceeding

Plaintiff,

Case No. 09-00504 (MG)

against

JPMORGAN CHASE BANK, N.A., *et al*.,

Defendants.

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PLAINTIFF'S MEMORANDUM OF LAW
IN RESPONSE TO ORDER DIRECTING ADDITIONAL BRIEFING

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Plaintiff Motors Liquidation Company Avoidance Action Trust (the "**Trust**") respectfully submits this memorandum of law in response to this Court's request for additional briefing on the opinion of the Special Court in *Matter of Valuation Proceedings Under Sections 303(c) and 306 of Reg'l Rail Reorg. Act of 1973*, 445 F. Supp. 994 (Special Ct. R.R.R.A. 1977).

BACKGROUND

In the early 1970s, the commercial railroad industry of the United States was confronted with an economic crisis not unlike that faced by the American automotive industry in 2008-2009. Declining markets, increasing competition, and general mismanagement had led to the failure of several key railroads—most conspicuously the Penn Central Transportation Company, then the nation's largest railroad—and was threatening the viability of the broader commercial railroad system in the Midwest and Northeast regions of the United States. S. Rep. No. 93-601, *reprinted in* 1973 U.S.C.C.A.N. 3242, 3246-48 (1973). In response to the crisis, Congress enacted the Regional Rail Reorganization Act of 1973 (the "Rail Act"), with the objective of preserving rail service operations in the affected regions by "replacing them with a new and viable rail services system." *Id*. at 3242; *see also Valuation Proceedings*, 445 F. Supp. at 1025 (Rail Act "designed to preserve a failing transportation system from completely disappearing. . . ."). To this end, a government-sponsored entity—the Consolidated Rail Corporation ("**Conrail**")—was created for the purpose of acquiring the assets of bankrupt railroads and putting those assets to continued use. *In re Penn Centr. Transp. Co.*, 384 F. Supp. 895, 906 (Special Court 1974).

The Rail Act provided for the creation of a Special Court to adjudicate disputes arising under the statute. In a series of valuation proceedings of relevance here, the Special Court was charged with determining the value of certain rail assets acquired by ConRail pursuant to the Rail Act. Although the Special Court addressed valuation in the condemnation context, there are direct parallels between the issues considered in the Special Court's valuation proceedings and

the issues currently before this Court with respect to the valuation of the forty representative assets (the "**Representative Assets**"). Notably, the asset acquisitions were in both cases effectuated through a government-sponsored entity and were in both cases driven by public policy imperatives, chiefly the United States Government's desire to safeguard the national economy from the threat posed by the imminent collapse of a vital national industry. *Valuation Proceedings*, 445 F. Supp. at 1011 n.22 (citing legislative history of Rail Act).[1]

ARGUMENT

Three broad principles of direct relevance to this litigation can be distilled from the *Valuation Proceedings* opinion. First, market value is to be given presumptive priority as a standard of valuation, with original cost serving as an alternative second-order measure of value where realistic market valuation is not feasible. Second, where the federal government interposes itself to acquire private assets for the public interest, the value of those assets should be determined as if the government had not intervened. Third, no "going concern" value may properly be ascribed to the assets of a failing business enterprise with no ability to generate profits and, absent government intervention, no capacity to sustain its own operations.

I. MARKET VALUE IS TO BE GIVEN PRIORITY AS A STANDARD OF VALUATION

A. The Special Court Found Market Value To Be The Presumptive Standard Of Value

The Special Court found that market value was to be given presumptive priority as a standard of valuation. *Valuation Proceedings*, 445 F. Supp. at 1011-16 (acknowledging "market

[1] Here, unlike in *Valuation Proceedings*, "just compensation" under the Fifth Amendment is not at issue. Consequently, the proceedings here do not implicate the Fifth Amendment principle of indemnity, under which the owner of condemned property may be entitled to more than fair market value—the presumptive measure of "just compensation"—where such value falls short of the peculiar value ascribed to the property by its owner. *See U.S. v. Certain Prop. in Borough of Manhattan*, 403 F.2d 800, 802-03 (2d Cir. 1968).

value," or "what a willing buyer would pay a willing seller," as the conventional standard). Even under circumstances where market value may be "particularly hard to prove"—*e.g.*, due to idiosyncrasies in the relevant market—the Special Court cautioned that the "role of market value" was not to be rejected out of hand. *Id*. at 1029. It is only where the "unique circumstances" of a case "make it impossible to establish a market value" that a court may be constrained to "resort to some other rule." *Id*. at 1030. In such instances, the Special Court suggested that "original cost," subject to "appropriate deductions," was an alternative basis for valuation "most deserving of serious consideration" as a "possible check" on facially implausible market-based valuations. *Id*. at 1029-31, 1045. Accordingly, although the Special Court did not perceive "original cost" to be the "best indication" of value, *id*. at 1031, it advised the parties that "resort to some kind of analysis related to original cost" could become necessary should it "prove impossible to establish a market value which constitutes just compensation." *Id*. at 1030-31.

The Special Court squarely rejected several other alternative valuation standards proposed by the railroads—including reproduction cost, "trended original costs," and value of materials "in place"—on the ground that such measures reflected "neither values which the transferors were in a position to realize at the time . . . nor an amount deriving from what they had invested." *Id*. at 1031, 1036-37. The Special Court dismissed these measures as the "fantasies of 'experts'" that would "provide a bonanza to investors" well beyond anything that could have been envisaged in the "dark days" of the rail crisis. *Id*. at 1045. The Special Court singled out reproduction cost in particular for extensive discussion, rejecting this measure of value as conceptually defective and observing that the reproduction cost approach yielded extravagantly inflated estimates of value. *Id*. at 1031-37.

The Special Court likewise rejected "going concern" value, finding "going concern" valuation inappropriate because the rail assets in question, though intended for continued use in the hands of the government-sponsored entity, had not been profitable in the hands of their original owners. *Id*. at 1037 n.54, 1041 (noting that the "condemned rail properties have been taken for continued rail use"). More broadly, the Special Court was clear that it would countenance no valuation methodology that ascribed more value to the "properties in their deaths than they had been worth during their recent lives." *Id*. at 1032. As the Special Court explained, the United States Government's commitment to preserve the rail system and avert economic crisis through the seizure of the rail assets afforded "no basis" for ascribing values to such assets "which their owners could never have realized except through condemnation by the Federal Government." *Id*. at 1045.

Significantly, in choosing among these standards, the Special Court noted a desire to avoid the prospect that valuation of the rail assets could devolve into a "prodigious and time-consuming effort in conjecture" given the unique nature of the assets—railroad lines—and the necessarily hypothetical nature of market sales of such assets. *Id*. at 1044-45. Such concerns are not present here, as the Representative Assets include much equipment of the sort commonly traded on active secondary markets, such that market values can be reliably derived from existing data on actual sales of similar assets. Direct Testimony of David K. Goesling ("Goesling Direct") ¶¶ 408-10, 456-57. While the total number of assets to be valued in this litigation remains undetermined—the final number will depend on the resolution of the classification issues—the standards established by the Court in this representative proceeding will provide a basis for extrapolating total value (*e.g.*, based on category or type of asset).

B. The Valuation Methodology Applied By The Trust's Appraisal Expert Is Consistent With The Special Court's Guidance

The approach to valuation taken by the Trust's appraisal expert, David K. Goesling, is consistent with the Special Court's guidance in *Valuation Proceedings*. In appraising the Representative Assets, Mr. Goesling gave first priority to market value, applying the market approach wherever there was sufficient market data to do so and grounding his valuation on the prices that the assets would have obtained on the secondary market. *See* Goesling Direct ¶¶ 387, 407-11. In applying the market approach, Mr. Goesling generally estimated value based on actual market prices and/or asking prices for comparable assets, adjusting, as appropriate, for factors such as the timing of the sale or the location, type, age, and condition of the equipment. *See id*. ¶ 408-09. Mr. Goesling considered scrap value in those instances where the asset in question appeared to be marketable only as scrap, *see id*. ¶ 410, an approach fully consistent with the finding of the Special Court that the market value of an asset consists of the higher of its "scrap value" or its "sales value." *Valuation Proceedings*, 445 F. Supp. at 1016.

Mr. Goesling did not apply market value in those instances where there was no market for the asset or where, due to a lack of comparable sales transactions, historical cost proved to be a more reliable guidepost to value. Consistent with the approach recommended by the Special Court, Mr. Goesling applied a cost approach as an alternative where comparable market data was not available, basing his valuation on historical cost data and making necessary deductions to account for physical deterioration, functional obsolescence, and economic obsolescence. *See* Goesling Direct ¶¶ 399-402, 411. Mr. Goesling's use of a cost approach as an alternative to market value conforms with the Special Court's suggestion that "original cost subject to appropriate deductions" may be a permissible—and perhaps optimal—recourse if market value is "impossible to establish." *Valuation Proceedings*, 445 F. Supp. at 1030, 1045.

By contrast, the approach taken by the Defendants' expert, Carl C. Chrappa, turns the guidance of the Special Court on its head: Mr. Chrappa rejected the market approach outright and relied exclusively on the cost approach in the first instance. *See* Direct Testimony of Carl C. Chrappa ("Chrappa Direct") ¶¶ 5, 25, 39, 45-53; *see also* Goesling Direct ¶¶ 454-57 (observing that Mr. Chrappa disregarded market value even with respect to commonly traded assets with active markets). Similarly, the personal property valuation performed by KPMG LLP ("**KPMG**")—upon whose interim reproduction / replacement cost values the Term Lenders seek to rely—was predicated almost entirely on a cost approach; KPMG limited its use of the market approach to computer software and computer equipment and to a narrow subset of assets identified as idle or abandoned or scheduled for disposal. Defendants' Exhibit 141 ("KPMG Report") at DX-0141-0140-41.

Mr. Chrappa's rationale for his uniform rejection of market valuation is telling. It is not the case that the Term Lenders tried but were unable to "prove market value with sufficient nicety" and thus were obliged, through "no fault of their own," to resort to an alternative valuation standard. *Valuation Proceedings*, 445 F. Supp. at 1045. Rather, recognizing that many of the Representative Assets had value on the secondary market, but only a "limited" value, Mr. Chrappa eschewed "fair market value" as a standard of valuation altogether and opted instead to appraise the assets on the basis of their unique (and "tremendous") value to *New GM*. Chrappa Direct ¶¶ 25, 39.

As discussed below, *see infra* Section II, the Special Court's decision in *Valuation Proceedings* makes clear that the value of assets to a government-sponsored entity—one created as a vehicle for bailing out a hopelessly failing business enterprise—is not the appropriate measure of the value of the assets from the perspective of the failing business enterprise.

Valuation Proceedings, 445 F. Supp. at 1013-16, 1029 n.46; *see also In re Residential Capital, LLC*, 501 B.R. 549, 595 (Bankr. S.D.N.Y. 2013) ("[I]n determining the value of the [collateral] on the Petition Date, the Court must apply that value based on the proposed disposition of the collateral—*fair market value in the hands of the Debtors*") (emphasis added)); *In re Motors Liquidation Co.*, 482 B.R. 485, 494-95 (Bankr. S.D.N.Y. 2012) (rejecting valuation standard based on value to particular person or firm). Relatedly, it is well-established that compensation for an eminent domain taking is properly measured by the owner's loss, not by the taker's gain. *See Boston Chamber of Commerce v. City of Boston*, 217 U.S. 189, 195 (1910); *see also Valuation Proceedings*, 445 F. Supp. at 1013-14, 1029 n.46 (rejecting "value to the taker as a measure of the transferors' compensation"). Similarly, it is the value of the Representative Assets in the hands of Old GM—not their value in the hands of the government-subsidized New GM—that must govern here.

There are, of course, a wide variety of ways to approach the valuation question, as the Special Court recognized when it suggested that there was "perhaps . . . some better way" than market value or "original cost" to arrive at a figure for just compensation. *Valuation Proceedings*, 445 F. Supp. at 1045. The Trust believes that Mr. Goesling's market-based approach is the best approach to valuation here. It provides a sound methodology and is consistent with the approach advanced by the Special Court. However, we note that Mr. Goesling determined cost-based values for each of the Representative Assets, even those for which Mr. Goesling determined that market value was the more reliable standard of value. Goesling Direct ¶ 412 (setting forth cost approach value indication and market approach value indication for the Representative Assets). An alternative approach the Court may wish to consider would be application of Mr. Goesling's cost-based methodology, subject to an

economic obsolescence discount applied uniformly across each asset category. Were the Court to conclude that such an approach better fits the circumstances of this case, it would require some modification to Mr. Goesling's cost-based methodology, but, as modified, the methodology could be applied uniformly across the full universe of assets. In addition, Mr. Goesling has performed an alternative valuation based on "Liquidation Value in Place," premised on the counterfactual assumption that the Representative Assets would have been sold in the aggregate, as part of a sale of all of the relevant plants. Goesling Direct ¶¶ 428-53. The Trust does not subscribe to this alternative methodology, as its underlying assumptions are contrary to actual market conditions as of the Valuation Date, but nevertheless believes that this Court's deliberations may benefit from review of the broadest possible range of valuation methodologies.

II. THE REPRESENTATIVE ASSETS SHOULD BE VALUED AS IF THE GOVERNMENT HAD NOT INTERVENED

The Special Court additionally held that the condemned rail assets were to be valued not on the basis of their value to the United States Government, but on the basis of what their value would have been in the absence of the United States Government's intervention. *Valuation Proceedings*, 445 F. Supp. at 1016; *see also Matter of Valuation Proceedings under Sections 303(c) and 306 of Reg'l Rail Reorg. Act of 1973*, 531 F. Supp. 1191, 1210 (Special Ct. R.R.R.A. 1981) ("The CMV Opinion established that the [transferors] are entitled to compensation for the properties conveyed by them . . . for whatever they could have realized for them in the absence of the Rail Act."). The Special Court's holding has direct relevance here, because condemned property, like collateral under Section 506(a), is "generally to be valued on the basis of what a willing buyer would pay a willing seller," *Valuation Proceedings*, 445 F. Supp. at 1012; *Residential Capital*, 501 B.R. at 591-92, and the role of the United States Government here, as in *Valuation Proceedings*, was "certainly not that of a 'willing buyer.'" *Valuation Proceedings*, 445

F. Supp. at 1005. Indeed, the Section 363 sale here, like the acquisition at issue in *Valuation Proceedings*, was undertaken not for commercial reasons, but as an emergency measure aimed at forestalling the anticipated disastrous economic consequences of the collapse of a vital sector of American industry. Consistent with the opinion of the Special Court, the Representative Assets should be valued on the basis of whatever prices the assets would have commanded in the absence of the government-sponsored purchase.

The Special Court held that the value of the seized assets to the United States Government was not a proper measure of their compensable market value. *Id*. at 1015 ("[A]ttempting to reconstruct a bargaining process between the transferors and the United States" would be "inconsistent with the basic principle of eminent domain."), 1029 n.46 ("[W]e have refused to consider value to the taker as a measure of the transferors' compensation."). As the Special Court explained, market value must be "determinable in accordance with some external standard," without reference to the value accorded to the assets by the United States Government. *Id*. at 1015. Thus, in valuing the condemned rail assets, the "special value" of those assets to the United States Government "must be excluded as an element of market value." *Id*. at 1014 (quoting *U.S. v. Miller*, 317 U.S. 369, 375 (1943)). While the assets acquired under the Rail Act were obtained through condemnation, rather than through Section 363 sale, a similar analysis obtains here: Because the United States Government was not acting as a commercially-motivated investor, the unique value of the Representative Assets to New GM—a value that could never have been realized but for the intervention of the United States Government—is not a proper foundation for valuation of the Representative Assets. *Id*. at 1045. Rather, in order fairly to assess the value of the Representative Assets, the United States Government's intervention

must be factored out, and the appraisal must proceed on the premise that no government subsidy was extended.

III. GOING CONCERN VALUE CANNOT BE ASCRIBED TO THE ASSETS OF A FAILING BUSINESS ENTERPRISE

Finally, the Special Court unequivocally rejected "going concern" value as a measure of the value of the seized rail assets. *See Valuation Proceedings*, 445 F. Supp. at 1037 n.54 (rejecting contention that transferors were "entitled to an allowance for the 'going concern' value of their properties despite their unprofitability"). The reasoning of the Special Court was straightforward: The "hopelessly losing railroads" were not going concerns at all. *Id*. at 1015. As the Special Court observed, "[e]conomic viability, i.e., the capacity to operate at a profit, is . . . the sine qua non for an award of going concern value." *Id*. at 1037 n.54 (quoting *In re Port Auth. Trans-Hudson Corp. v. Hudson Rapid Tubes Corp.*, 20 N.Y.2d 457, 480-81 (1967) (Burke, J., dissenting)); *see also In re Diplomat Elecs. Corp.*, 82 B.R. 688, 692 (Bankr. S.D.N.Y. 1988). That the seized assets of these "hopelessly losing railroads" were put to continued use by a government-sponsored entity did not change the analysis; the Special Court concluded that the assets could not be ascribed any "going concern" value, notwithstanding their continued use in the hands of the government-sponsored entity, because the proper focus of the valuation analysis was the status of the transferors, not that of the transferee. Accordingly, no "going concern" value could be ascribed to the transferred assets inasmuch as the transferor railroads had been "hopelessly losing" and, absent government intervention, were "destined to remain so." *Valuation Proceedings*, 445 F. Supp. at 1011, 1037 n.54.

In short, the *Valuation Proceedings* opinion instructs that "going concern" value is not a proper standard for valuing the assets of a doomed business enterprise that could only continue as a "going concern" through the intervention of the federal government. *Id*. at 1037 n.54, 1045.

The conclusion has direct implications here, for as of June 30, 2009, Old GM could not continue as a going concern absent government intervention; Old GM was not only unable to generate profits, it was on the brink of total liquidation. *See In re General Motors Corp.*, 407 B.R. 463, 493 (Bankr. S.D.N.Y. 2009) ("[T]he only alternative to an immediate sale is liquidation."). It was a "certainty or near certainty" that, absent government intervention, the "patient will indeed die on the operating table." *Id.* at 492 n.54.[2]

Accordingly, and consistent with the findings of the Special Court, Mr. Goesling employed the "value in exchange" premise of valuation and rejected "value in continued use," on the grounds that Old GM's assets "did not have value as part of a going concern as of the Valuation Date." Goesling Direct ¶¶ 387, 428. KPMG, by contrast, valued the assets as "part of a going concern business" (except in those instances where the asset was to be retired or sold), because its task was to value the assets in the hands of *New GM*. KPMG Report at DX-0141-0118. Mr. Chrappa, too, ascribed "going concern" value to the bulk of the Representative Assets, reasoning that "going concern" valuation was appropriate because the assets were to be used by *New GM* as "part of a going concern." Chrappa Direct ¶¶ 4, 22, 27, 31, 121, 134. The unsuitability of these "going concern" valuations for purposes of the current proceeding is plain: What is at issue here is the value of the Representative Assets in the hands of *Old GM*, not their value after their conveyance to the government-sponsored entity, New GM. As Mr. Goesling's analysis recognizes, the Representative Assets had no going concern value in the hands of Old GM, because, like the railroads at issue in *Valuation Proceedings*, Old GM was not a "going concern," but was in fact "hopelessly losing" and "destined to remain so." *Valuation*

[2] In a dissenting opinion cited favorably by the Special Court, Judge Burke described the "dismally unprofitable railroad" at issue in that case in terms that apply with equal force to Old GM: "No private purchaser would think of taking it over for purposes of continuing its operations. Commercially, its liquidation value was all the owners could hope to realize." *Port Auth. Trans-Hudson Corp.*, 20 N.Y.2d at 476 (Burke, J., dissenting).

Proceedings, 445 F. Supp. at 1011. That *New GM*, infused with an enormous government subsidy, was able to put many of the Representative Assets to use, says nothing about the value of those assets in the hands of Old GM. *See Residential Capital*, 501 B.R. at 595.

CONCLUSION

For the reasons set out in the Trust's pre-trial memorandum and herein, the Court should adopt the valuation methodology employed by the Trust's appraisal expert, which will be the subject of testimony at the forthcoming trial on the classification and valuation of the Representative Assets.

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New York, New York

Respectfully submitted,

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