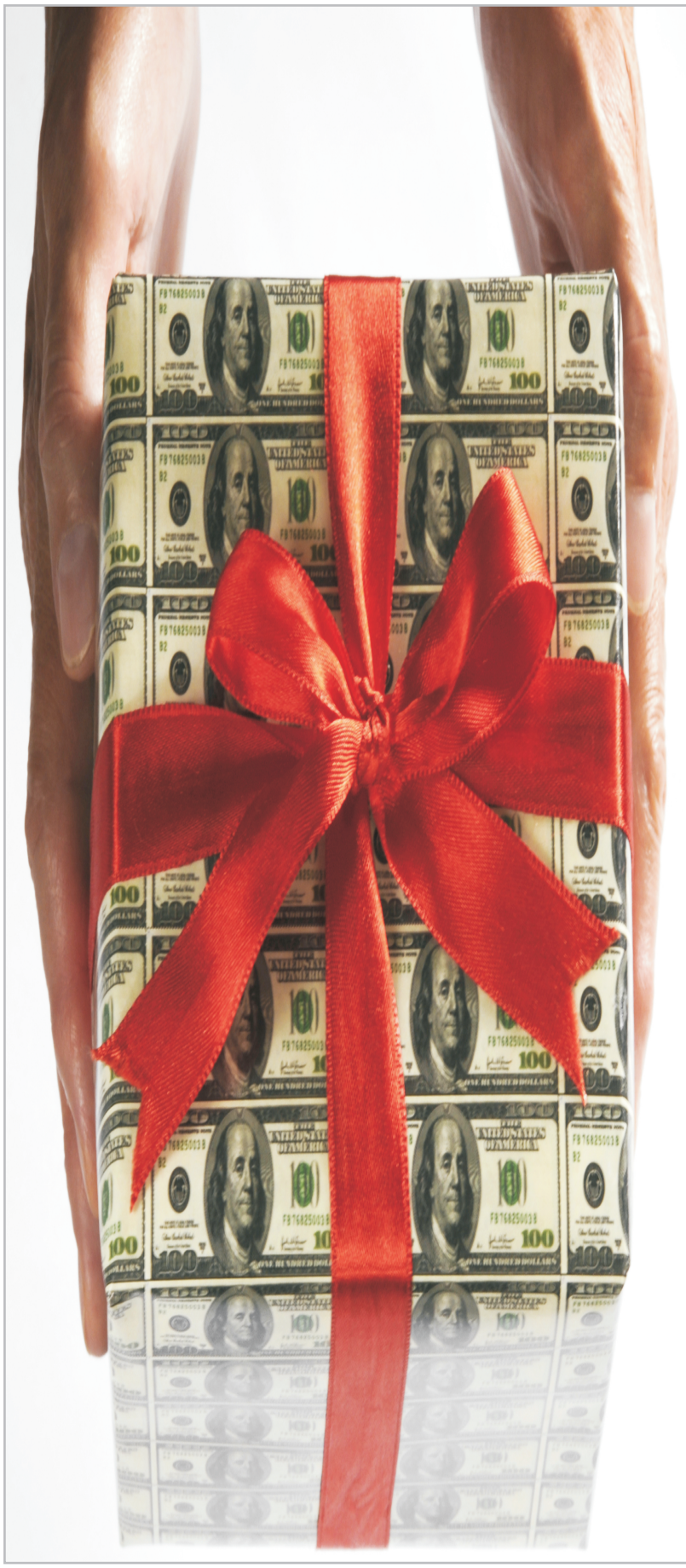


GAMING BANKRUPTCIES DON'T MISS THE TAX BENEFITS IN DEBT FOR EQUITY EXCHANGES

By Michael E. Kearney

The most dramatic and sustained recession to hit Nevada since the advent of legalized casino gaming has lead to sights unimaginable five years ago: abandoned casino projects littering the landscape, down gaming win, and gaming operators, burdened by unsustainable debt levels, wallowing in bankruptcy. The list of companies seeking bankruptcy protection is a veritable who's who of Nevada gaming, such as Station Casinos and Tropicana Entertainment, not to mention newcomers M Resort and Fontainebleau.

The market for Nevada gaming properties is so poor that few third-party bidders are acquiring gaming properties through bankruptcy. Natural buyers (existing gaming operators) are all hurting or look to generate higher returns in greener fields in Asia or states recently approving casino-style gaming. Financial buyers are burdened with portfolios containing underperforming gaming debt. Lenders have been forced to take over bankrupt gaming properties in debt-for-equity exchanges and to install professional management. These lender-reorganized bankruptcies are painful to the lenders and present tricky gaming control issues, but they also present an opportunity for preserving significant tax benefits.

Nevada's stringent regulatory requirement that all holders of equity in a gaming entity be found suitable by Nevada gaming regulators,

unless the entity is a "public company," traditionally served as a "barrier to entry" for financial buyers looking to own more than 10% of a Nevada gaming entity. Generally, use of the term "public company" is a reference to the term "publicly traded corporation" (a somewhat misleading definition) defined under NRS 463.487, which may be an LLC or corporation that (i) has a class of public debt registered under Section 12 of the Securities Exchange Act of 1934, **or** (ii) is an issuer subject to section 15(d) of the 1934 Act. The "barrier to entry" has been reduced by expansion of "institutional investor" waivers (permitting institutional investors to hold up to 25% of the equity of a "public company" without undergoing a full suitability determination), coupled with Nevada's approval of innovative ownership structures involving non-voting equity securities.

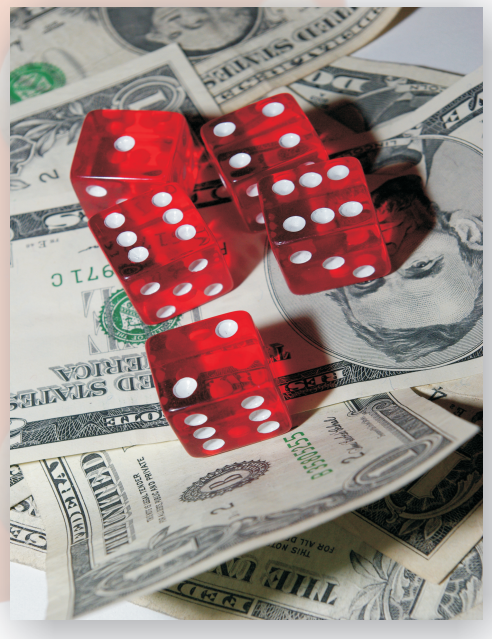
Lenders faced with reorganizing a bankrupt gaming company may qualify the reorganized company as a "public company" if the plan of reorganization involves a substantial debt component that justifies registration with the Securities and Exchange Commission ("SEC"). Alternatively, lenders can register one or more classes of equity securities of the reorganized debtor by filing an SEC Form 10. Although such a filing is not a registration statement for the sale of securities, SEC approval of the Form 10 nevertheless qualifies the company for registration with the Nevada state gaming authorities as a "public company." The ten percent (10%) licensing threshold applies only to voting securities, and variations of a "VoteCo/HoldCo" structure have been approved in Nevada, permitting passive equity holders in holding companies (most particularly, fund investors in private, equity-sponsored limited partnerships) to hold an economic interest in the gaming operator ("OpCo") by holding, indirectly, non-voting equity securities. The basic "VoteCo/HoldCo" structure envisions that OpCo issues all of its voting equity to a holding company ("VoteCo"), which exercises all management control over OpCo, while issuing non-voting equity to a holding company owned by the passive institutional investors ("HoldCo"). Accordingly, a "Voteco/HoldCo" provides a ready structure to lenders forced to operate a gaming operation post-bankruptcy.

The Tax Benefits

The tax accounting balance sheets of companies that piled on "cheap" debt at high EBITDA multiples to build hotel casinos or to acquire other gaming companies will reveal huge capitalized costs for buildings and equipment, in the case of new construction, and/or large goodwill in the case of acquirors. These corporations may have significant net operating losses available for carryforward ("NOL's"). Generally, for tax purposes, buildings generate depreciation deductible ratably over 39 years, while goodwill generates amortization, deductible ratably over 15 years. The tax benefits of these "loss corporations" (generally, a corporation with an NOL carryforward and/or where the aggregate basis of the assets exceeds the fair market value of the assets (net unreleased built-in-losses - "NUBIL")) are assets worth preserving in the case of a reorganized debtor that is to be controlled by creditors; hence, the need to properly structure the reorganization by preserving the tax entity possessing the tax benefits.

Corporate Reorganizations

It is possible for a loss corporation's NOL's and other tax benefits, including the carryover of high basis in assets, to survive a bankruptcy if the loss corporation is preserved and historic creditors control the company post-bankruptcy. Under Section 382 of the Internal Revenue Code (I.R.C.), if an ownership change occurs with respect to a loss corporation, the amount of the loss corporation's taxable income for a post-change year that may be offset by the NOL carryforwards arising before the ownership change and the depreciation and amortization deductions attributable to NUBIL assets ("RBILS" in tax parlance) are subject to a limitation known as the "Section 382 limitation." An ownership change under Section 382 consists generally of any change of ownership of a loss corporation's stock aggregating more than 50 percentage points (by value) over a three year period.



The Section 382 limitation generally equals the fair market value of the stock of the corporation immediately before the ownership change, multiplied by the long-term tax exempt rate as published in the Internal Revenue Bulletin. For example, assume that a gaming company has a $40 Million NOL carryover, and also a casino building having a capitalized cost of $600 Million. Assume further that the company is reorganized and has a value of $200 million as of the date of confirmation of the plan. The Section 382 annual limitation would be $8,340,000 based upon the June 2011, long-term tax exempt rate of 4.17%. Accordingly, only $8,340,000 in NOLs may be taken in any post change year.

The Section 382 limitation does not apply if the loss corporation is in a Chapter 11 bankruptcy proceeding and after the reorganization, such corporation is owned by pre-reorganization creditors or a combination of such creditors and historic shareholders. This bankruptcy exception only applies if the reorganization is ordered by the court or is effected pursuant to a plan approved by the court.

Generally, this bankruptcy exception applies if shareholders and/or certain qualified creditors of the loss corporation own stock representing 50% or more ownership (by vote and value) of such corporation as a result of the bankruptcy reorganization. It is extremely unlikely that old shareholders of the loss corporation will retain their stock in the reorganized debtor because of the "absolute priority rule" of the Federal Bankruptcy Code Section 1129(b) (generally providing that equity is wiped out unless all creditors are paid in full or agree by a two third's vote in amount and and-half in number to accept something less). It is unclear whether historic shareholders who contribute new equity to the reorganized debtor in return for stock are counted for purposes of the change in control.

Stock transferred to a creditor (a "qualified creditor") is taken into account for purposes of satisfying the continuing 50% ownership requirement only if such stock was transferred in satisfaction of: (a) indebtedness held by the same beneficial owner for at least 18 months prior to the filing of the Title 11 bankruptcy case, or (b) indebtedness incurred in the ordinary course of

the trade or business of the loss corporation such as trade debt or a claim that arises upon the rejection of a burdensome contract or lease in the bankruptcy proceeding. Given the long timeline for approval of a bankruptcy plan of reorganization, SEC approval of registration (whether debt or equity) and most importantly, the lead time for Nevada approval of a lender reorganization, the 18 month holding requirement is not as daunting as one might imagine. Historic lenders looking to "pre-package" a gaming bankruptcy should be cognizant of this time period in terms of the customary "support agreement" that should prohibit consenting creditors from transferring debt so that the creditors may benefit from the bankruptcy exception.

Note, however, that satisfaction of the 50% control requirement is very problematic in a gaming bankruptcy, owing to the requirement that the historic creditors and shareholders hold 50% of the voting power post-bankruptcy. Lenders forced to

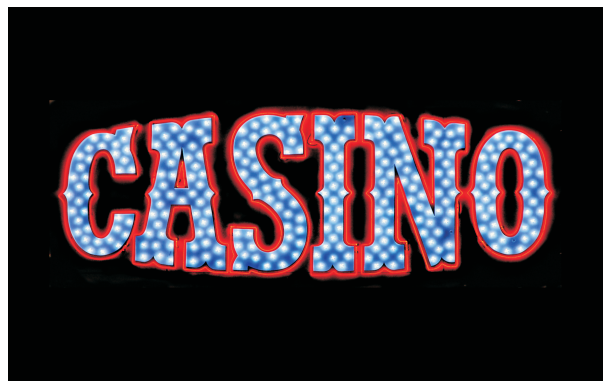
adopt a variant of the VoteCo/HoldCo structure are probably not going to satisfy the 50% voting power requirement. It may be possible to satisfy the 50% voting power requirement by lenders holding institutional waivers in a traditional "public company" scenario. However, it must be emphasized that even if this bankruptcy exception will not apply, taking the entity subject to the Section 382 limitation (i.e., preserving the tax history of the bankrupt entity) still makes sense.

It is entirely likely that in corporate bankruptcy reorganization, the debtor corporation will realize substantial cancellation of indebtedness ("COD") income. In all bankruptcy reorganizations, available NOL's are reduced by COD income and a portion of the interest paid on any debt cancelled or converted into stock. If the COD income exceeds the amount of the NOL and other tax credits, then the basis of depreciable/amortizable assets are reduced. Accordingly, in many corporate bankruptcies, it would initially appear that preservation of tax benefits in the form of NOL's would not be a "driving force." However, even if all NOL's are eliminated, preservation of high inside basis in assets that exceed the fair market value of the reorganized debtor can be a "plum" tax attribute. Moreover, in multi-property bankruptcies, the actual debtor realizing COD income may be a parent holding company and not the operating subsidiary that holds the high basis assets. In this case, the high basis assets of the subsidiary may not be reduced by COD income.

As noted above, the Section 382 limitation also limits RBIL deductions arising out of NUBIL assets. RBILs are generally deductions and losses that are "built-in" at the change date and that are taken into

account by the new loss corporation during the five-year period beginning on the change date. So, for example, in the case of the loss corporation described above that has a $600 million basis in its building, assuming that there is $240 million in COD income that eliminates the $40 million NOL and reduces the basis of the building to $400 million, the annual depreciation deduction otherwise available of $10,256,000 per year would be limited to the Section 382 limitation of $8,340,000, as calculated above during the five year period.

The NUBIL limitations are not as punitive as the general Section 382 limitation applicable to NOL's, since RBIL deductions are limited for only five years, and any deduction that is disallowed because it exceeds the Section 382 limitation during this five year recognition period can be carried forward generally for twenty taxable years. So, in the above example, after five years the depreciation deduction jumps back up to $10,256,000 plus the amount of the depreciation deduction disallowed over the five year period (a total of $9,580,000), which is then available. Furthermore, the high basis will be



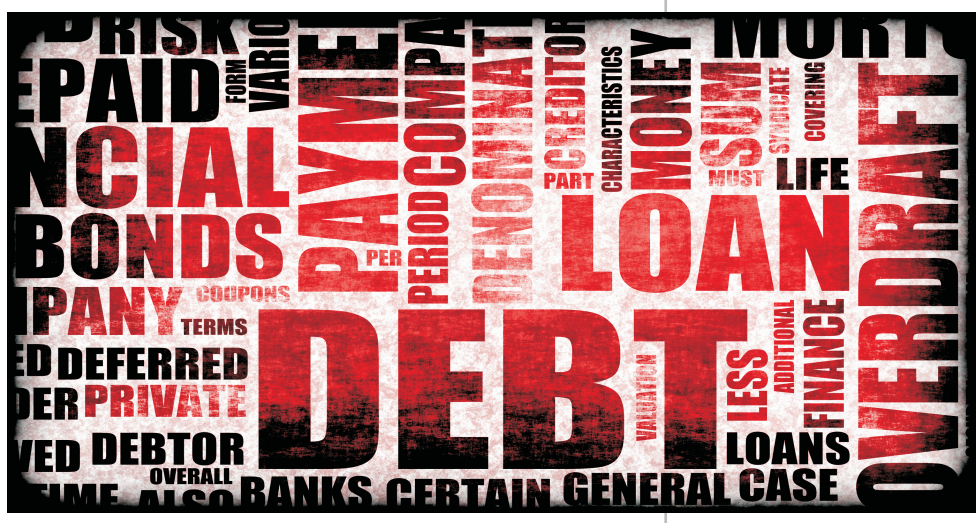
available to reduce potential gain on sale of the assets at the time the lenders sell the company to the next operator.

The lesson to be remembered is that in a corporate bankruptcy, high basis assets may be preserved by retaining the reorganized debtor entity irrespective of the quantum of voting control held by the historic creditors.

LLC Reorganizations

Many recent gaming bankruptcies involve limited liability companies taxed as partnerships for tax purposes. Unlike corporate bankruptcies, survivability of NOLs is not an issue, since operating losses pass through to the individual partners/LLC members. There are no hard and fast limitations, such as the Section 382 limitation, applicable to LLC bankruptcies in terms of voting control. More specifically, the lenders may wind up with owning the majority of the economic interests in the reorganized debtor without holding any voting interest, and are not subject to "qualified creditor" requirements. Hence a VoteCo/HoldCo structure may be more efficacious in the LLC bankruptcy setting.

The question in an LLC gaming bankruptcy is whether lenders who reorganize the company by participating in a debt-for-equity exchange succeed to the LLC's high inside basis in the assets. Under I.R.C. Section 108(e)(8), if a debtor LLC/partnership transfers a capital or profits interest in the LLC/partnership to a creditor in satisfaction of its debt, the debtor is treated as having satisfied the debt with money equal to the fair market value of the LLC/partnership interest. Treasury regulations provide that the COD income thus realized (difference between fair market value of the interest and the amount of the debt) is allocated to the historic equity holders. The historic



equity holders are given the option to reduce the "inside basis" of the assets of the partnership/LLC. However, it is unclear that this option is available in connection with the complete extinction of the historic partnership/LLC interests in the case of confirmation of a plan of reorganization since the historic creditors no longer own any interest. Moreover, with the consent of historic equity holders (such as LLC members who can be persuaded to cooperate or face independent actions on personally guarantees), a bankruptcy court can assume jurisdiction over historic members solely to facilitate a plan (and the IRS must honor such assumption). Accordingly, it is entirely possible for the lenders to end up with the carryover of the LLC's high tax basis assets.

A creditor who receives an LLC/partnership interest in a debt-for-equity exchange generally realizes no gain or loss, except in satisfaction of a partnership's obligation for unpaid rent, royalties, or interest. In addition, under the general partnership tax rules, the lender's basis in the LLC/partnership interest is equal to the lender's basis in the debt extinguished. If the lender's basis in debt to be extinguished is higher than the lender's share of the "inside basis" of the LLC's assets, the lender should consider taking a bad debt deduction under I.R.C. Section 166 in respect to the "partial" worthlessness of the debt.

Realistically, the decision of lenders to assume ownership of a reorganized LLC or partnership gaming company in a bankruptcy is a worst case scenario. Lenders facing a bankruptcy filing by a Nevada gaming company need to be prepared for the worst case (lender ownership of the company post-bankruptcy), and attempt to preserve favorable tax benefits that may succeed to the lenders in connection with preserving the historic tax entity.

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