IN AND OUT OF BANKRUPTCY: WEATHERING THE FINANCIAL STORM IN GAMING

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As everybody is aware, the recent economic turbulence facing the United States (and the world for that matter) has greatly impacted the casino gaming industry. Many institutional investors on Wall Street, as well as private equity firms and large national/international banks, either own equity in, or have lent money to, public and private gaming companies. Many of these loans were made at the top of the market with high debt leverage ratios, anticipating that casino revenues would remain at historical levels or would continue to climb. However, because gaming is essentially an entertainment industry, the economic tumult precipitously reduced consumer discretionary spending, leading to deflated casino revenue. As a result, casino profitability has suffered, major capital projects have been delayed or shelved completely, and many gaming companies have been unable to meet their income or other covenants in their debt obligations.

Faced with such challenges, both lenders and debtors in the gaming industry have been forced to develop solutions that are unique to casino businesses, whether in or out of the bankruptcy context.

Restructuring Alternatives

In the wake of financial defaults, gaming debtors and lenders often turn first to restructuring options in order to avoid the filing of a bankruptcy. Nevertheless, the novel aspects of the casino business present numerous difficulties for lenders.
Casinos are typically financed with a combination of secured and unsecured debt. They own property much in the same way as

any other business, which they can pledge to secure their debt. Unlike general commercial loans, however, the lender's relationship to the borrower and to the lender's collateral is regulated by state gaming laws. For example, in Nevada, the pledge of stock of privately owned gaming companies requires the prior approval of gaming authorities, as do some negative pledge covenants before they can be effective. The gaming licenses themselves are not subject to encumbrance, since they are considered a revocable privilege to conduct gaming activities. Nevertheless, lenders routinely take the position that the "enterprise value" of the casino is intangible personal property, allowing them to assert a security interest in that goodwill.

In addition to those regulatory issues, the casino business itself presents unique challenges to the lender. One of the most important characteristics of the gaming business is the amount of cash on hand in the casino. This cash is located in the casino cage, throughout the casino in gaming machines, at the gaming tables, and can be represented by chips. A lender's security interest in that cash can only be perfected by possession. However, because cash is the lynchpin of the gaming enterprise (and casinos need to maintain a minimum bankroll on hand per gaming regulations), a lender's actual possession of such cash would prohibit the continual operation of the casino. And, even if the lender were granted a security interest in gaming tables and slot machines, the lender does not automatically have a security interest in the cash generated by the use of that gaming equipment. There are no cases that address whether the revenue generated by such gaming equipment constitutes "proceeds" under the Uniform Commercial Code, but it is unlikely; because cash does not diminish the value of the lender's collateral when generated. Due to the uncertainty of these issues, lenders are increasingly requiring that borrowers structurally separate the ownership of the real estate from the operation, and that borrowers operate pursuant to such leases. As part of this structure, the lender generally requires the borrower to deposit cash into accounts controlled by the lender, which cash then "waterfalls" out to pay approved operating expenses and debt obligations.

In addition to the issues that arise in connection with the grant and perfection of a lender's collateral, loans to licensed gaming companies often create unique situations that impact a lender's ability to foreclose on the collateral. In Nevada, lenders cannot assume control of a Nevada gaming business without prior gaming regulatory approvals as to their suitability. The issue of how much decision making power a lender can have over a casino or gaming company without being deemed to be in control is often complex. Certain foreclosures of stock or equity also require prior approval of the lender by the gaming regulatory authorities. Although gaming devices may be foreclosed upon without prior approval from regulators, approvals are required to sell or further transfer those gaming devices and, when transferred, must be transferred to someone who already holds a manufacturer/distributor license. On the other hand, real property may be foreclosed upon without any gaming authority consent, which is why sophisticated lenders are requiring the bifurcation of the real estate from the operation.

For these reasons, sophisticated borrowers may attempt to use the gaming regulatory structure to their advantage against unsophisticated lenders. A borrower can use a lender's inability to take over and conduct gaming operations without the appropriate licenses as leverage to renegotiate the terms of a loan transaction after a borrower default. And lenders do not want the borrowers to force their hand in such an instance, because the only quick way to gain control of a gaming borrower's business would be to cease gaming operations, which would decimate the value of the collateral.

But increasingly, with the new borrowing structures, lenders are finding ways to restructure without the cost and delay of a bankruptcy filing. Oftentimes, leverage against personal guarantors is used by the lenders to gain negotiating power. For example, the parties to the senior secured loan on the M Resort

agreed that, rather than a foreclosure or bankruptcy; the parties would market and auction the property. Similarly, the Planet Hollywood lenders and owners agreed to sell the property to Caesar's Entertainment, f/k/a Harrah's Entertainment, rather than filing a Chapter 11 that would have constituted yet another bankruptcy for the former Aladdin property. More recently, the Palms announced that the owners had sold 98% of the equity in a transaction that erased $400 million of debt.

In the case of the Hard Rock, the senior secured lender and one of the mezzanine lenders made a deal to avoid property closure or bankruptcy. Essentially, the mezzanine lender (which was secured by an upstream grant of the ownership of the borrower) contracted with a licensable casino tenant to take over casino operations once the mezzanine lender foreclosed on the borrower's equity interest. The mezzanine lender filed applications with the Nevada State Gaming Control Board and obtained a temporary waiver of licensing so the foreclosure could take place and control of the casino operations could be passed along to a newly licensed casino tenant thereafter. The licensure of the casino tenant by the Nevada Gaming Commission happened at the same hearing in which the lender's temporary waiver was obtained.

Nevertheless, if the borrower and the lenders cannot agree on a consensual restructuring, borrowers will often file a Chapter 11 in order to gain negotiating leverage over the lenders. The casino business is naturally favored in this respect, simply because of the amount of cash it generates and the difficulties lenders face with respect to perfection of their security interests. In addition, once in bankruptcy, there are additional hurdles for lenders to face. As discussed above, generally some kind of diminution in the collateral is required for cash to become "proceeds" of collateral. And, although this is a complex topic beyond the scope of this article, in various other contexts, the Courts have been hesitant to find that cash generated as revenue from the operation of gaming collateral is "proceeds" of the collateral. If the cash in a casino is not proceeds of collateral, then after the bankruptcy filing, all of that cash becomes unencumbered and available for use in the administration of the bankruptcy. This pool of cash, coupled with the fact that most casinos have positive EBITDA, in many cases gives the borrower the leverage it needs over its lenders.

In general, however, all parties recognize that a restructuring, whether done through the bankruptcy process or not, should allow the casino business to remain open, employees to remain employed, and provide a mechanism for the borrower and its creditors to explore ways by which to maximize the value of the bankrupt company to maximize the return to creditors.

Key Issues in Casino Bankruptcies

Increasingly, borrowers and senior lenders may agree to restructure the gaming company, but agree that the borrower must still file a bankruptcy petition to achieve the terms of the agreement because of other junior creditor groups who have claims that need to be addressed in order to allow

the restructured company to have a fresh start. Sometimes this is referred to a "prepackaged plan" or "prepack," because the borrower and senior lenders agree on the terms of the plan before the case is filed.
Whether or not there is an attempt at a "prepackaged plan" under the umbrella of a restructuring deal, casino debtors are turning to bankruptcy filings in significant numbers to assist them in addressing financial difficulties.

There are three types of bankruptcies that are typically filed by casino debtors:

1- Chapter 11 reorganization with a debtor that generates enough cash flow to continue operations and/or has significant debtor-in-possession financing to justify the bankruptcy court allowing the debtor to continue to operate during the bankruptcy and allowing the debtor to offer a plan of reorganization to its creditors and to the bankruptcy court. Examples of this type of bankruptcy were: Herbst Gaming, Station Casinos, the Riviera, Stratosphere Casino and Hotel, Fitzgeralds Gaming Corporation, and the Aladdin Casino and Hotel. In each of these instances, the casinos were able to stay open and continue operations, while a reorganization plan was circulated to the creditors and the court.

2- Chapter 11 reorganization with a debtor that either does not generate enough cash flow to continue operations or does not have adequate debtor-in-possession financing to finance the bankruptcy long enough to go through a plan of reorganization process. In this instance, the bankruptcy court may order a Section 363 sale of the debtor's assets, which results in the property being marketed for sale. In such an instance, a stalking horse bidder will be solicited, and an auction will take place under the oversight of the bankruptcy court. In this scenario, the equity owners of the debtor are able to participate in the auction and bid for the assets. Examples of this type of bankruptcy were: The Resort at Summerlin, Stateline Casino, and the Siena Hotel Spa & Casino. In the first two of these instances, the casinos were able to stay open with the agreement that a sale process would be initiated right away. In the case of the Siena, the gaming business was shut down before the sale was conducted.

3- Chapter 7 liquidation with a debtor that doesn't generate positive cash flow and who doesn't have the ability to obtain debtor-in-possession financing to continue operations. In this type of situation, the bankruptcy court and the gaming regulators work together to appoint a trustee to take over operations and make efforts to liquidate/sell the assets. Examples of this type of bankruptcy were: The Maxim Hotel and Casino and Fitzgeralds Reno (when it was the sole remaining asset of Fitzgeralds Gaming Corporation that couldn't be sold when the buyer declined to purchase that property along with the other three).

Regardless of the type of casino bankruptcy, once a bankruptcy petition is filed, the fiduciary duty of the operators of the casino shifts from that of equity owners of the company to the bankruptcy estate

itself (and more specifically to all of the creditors). The point here is that the casino's operations should be allowed to continue so as to maximize revenues in order to make it more likely that all creditor constituency groups are able to recover as much as possible. Generally, the prior owner's equity is wiped out and is worth nothing, as the equity is last in priority to be paid out (i.e. all unsecured creditors would need to be paid in full to allow any payment to the equity).

Once the gaming borrower has filed for bankruptcy, the extensive state and local gaming regulatory schemes complicate the bankruptcy process. The federal bankruptcy law and the state and local gaming regulations may present competing goals. The goal of the federal bankruptcy law is to get creditors paid and to allow an ongoing business to emerge rehabilitated. On the other hand, gaming regulations are driven by public policies designed to protect consumers and the integrity of the gaming industry.

In addition to all encompassing policy issues, there are procedural issues as well. When a debtor files for Chapter 11, the "automatic stay" goes into effect, which both prohibits creditors from pursuing actions against the debtor and prevents the debtor from paying any claims that arose prior to the filing. Therefore, a company beginning the Chapter 11 process must immediately ask the Court for certain orders that will allow it to continue uninterrupted operations during the bankruptcy proceeding. These motions are designed to ensure that the debtor can maintain normal business operations with customers, employees, suppliers, customers and other stakeholders. The ultimate goal is to allow the debtor to continue generating funds to support ongoing operations, which will, in turn, permit the debtor to satisfy creditors and successfully complete its plan of reorganization. Typically, these so-called "first day orders" allow the debtor to pay their employees, trade creditors, tax authorities, to honor room reservations, convention contracts and deposits, to use the existing cash management system already in place, to retain attorneys and other advisors, to use estate assets (including cash) to conduct business operations, and to obtain financing to fund the administration of the bankruptcy.

Gaming authorities may be able to exercise "police power" to force the casino to honor obligations to its customers made prior to the bankruptcy filing and to honor the state and local taxes inherent in the business. While the Bankruptcy Code technically requires that, upon the filing of bankruptcy protection, a casino is to cease issuing and honoring pre-petition chips and recognize only new "post-petition chips," the first day orders of a gaming

debtor will include the authority to authorize payment of gaming chips and tokens (as well as ticket in-ticket out vouchers) in the ordinary course of business, address claims to casino cash, honor sports book wagers and deposits, authorize the debtor to retain pre-petition charge card accounts, and honor tour and travel commitments and other pre-petition room deposits, and to pay gaming taxes. Practically, a debtor casino could not compete in the highly competitive gaming industry if it was required to strictly follow certain requirements of the Bankruptcy Code. Casino customers must be able to exchange their cash for gaming chips, and the race and sports book and keno operators must be allowed to accept bets on future events and pay winners on demand. To maintain operations, the casino must honor each of those pre-petition obligations of the debt post-petition and with no interruption upon the bankruptcy filing.

Due to the role of the gaming authorities, in many cases, the debtor will inform the regulators about the bankruptcy and may even give them an opportunity to comment on certain relevant first day orders.

Obviously, financing of the administration of the bankruptcy is usually of paramount importance. However, because this funding triggers the same kind of regulatory scrutiny as non-bankruptcy funding, and is subject to the same constraints (cash perfection issues, non-assignability of the gaming licenses and regulatory approvals) loans to gaming debtors are complex (the so-called "DIP" financing or "debtor in possession" financing). If a debtor needs financing, the senior secured lenders often provide it in return for the debtor making all encompassing agreements as to the use of cash, budgets, and the exit strategy of the debtor and the lenders. In any case, even DIP financing requires the licensees to provide the appropriate notices to the gaming authorities. And, if such notification is not done, state gaming regulators could attempt to rescind the financing arrangement or take other disciplinary action against the casino debtor.

Additionally, once the case is ongoing, the debtor has the ability to accept (and assign) or reject executory contracts. In the context of a gaming business, executory contracts would include leases of gaming devices, although gaming regulations impact the timing of any assignment, as well as limiting the group of persons or entities to which those contracts are assigned.

Exit Strategies

During a Chapter 11 bankruptcy case, the debtor will propose a plan of reorganization based on its negotiations with creditors. There are several restructuring alternatives available to casino debtors seeking protection under Chapter 11 of the Bankruptcy Code. Among these alternatives is the refinancing of outstanding debt, selling assets pursuant to Section 363 of the Bankruptcy Code or a plan of reorganization, or converting debt to equity. Most plans of reorganization will include a combination of some or all of these restructuring alternatives.

In many cases, the easiest restructuring alternative available to a casino debtor is to refinance its existing debt. Lenders need to be aware that, as with the initial debt transaction itself, when a casino debtor proposes to refinance existing debt, the lenders are subject to being called forward by gaming regulators for full suitability investigations. Gaming regulators generally have the discretion to call lenders forward for licensing, but this is rarely exercised so long as the lenders are bona fide banking institutions. In addition, the refinancing of debt may require the prior approval of the gaming authorities. Thus, the debtor's ability to obtain the approval of its plan of reorganization by the bankruptcy court will likely be dependent on

the lender and/or the proposed transaction also being approved by the gaming authorities.

An equity swap is another restructuring option available to a casino debtor. In order to effectuate the equity swap, a significant amount of the debtor's creditors must accept the debtor's plan of reorganization (at least two-thirds in amount and a majority in number of those creditors voting in the class whose claims will be subject to conversion into equity of the reorganized entity). An equity swap will likely create gaming licensing issues for the lenders, the result of which will vary depending upon the nature of the entity in bankruptcy (public or private) and the jurisdictions in which that company does business.

A third restructuring option available to a casino debtor is to sell its assets to a third party. Any sale of assets by the casino debtor is subject to the bankruptcy court's approval, as well as gaming regulatory approval. An asset sale may be very beneficial to a creditor who is unwilling or unable to undergo the licensing or suitability scrutiny that is required in an equity swap. In the sale process, only the buyer, and its insiders and affiliates, will undergo such scrutiny. However, there are potential downsides for creditors with an asset sale. Most importantly, the asset sale is not guaranteed to yield the best recovery for creditors. Additionally, there is no assurance that the buyer will be able to obtain the required licenses in a timely manner and complete the sale.

Lenders may be able to avail themselves of certain licensing exemptions (i.e., public company status of the bankrupt entity, institutional investor status for members of the lending group, non-voting stock), but, if the lenders want to have an operational role with members of its constituency serving as officers, directors or key employees (or otherwise exercising control over casino operations), then these individuals would need to be identified and go through the full licensing process. Many large institutions and other creditors may not want their organizations or management to be subject to the intense regulatory review. And, until a creditor is found to be suitable by the gaming authorities, it cannot receive as a distribution an equity interest in the reorganized debtor under the plan of reorganization.

In regards to the various Chapter 11 bankruptcy scenarios described above, any plan of reorganization or sale would need to be submitted to all applicable gaming regulatory agencies for a licensing investigation and approval, even after the bankruptcy court approval is obtained. This essentially means that the debtor retains control of the operation pending the license investigation and approval, stalling the progress of the reorganization.

The gaming license investigations that may be necessary in such instances can range from a full-blown, new gaming investigation of a company that has never been licensed before in a jurisdiction (which would take the most time), to an updated investigation of a company that is already licensed in a jurisdiction. Of course, the more jurisdictions in which a gaming company does business, the more gaming regulatory agencies that come into play.

Going Forward

The effects of the current economic climate are significant, from credit tightening to unemployment, to limitations on discretionary income and spending. Yet, despite having to weather these storms, the casino industry is

continuing to evolve as courts, regulators, lenders, casino companies, and equity owners are facing the challenges posed by the ongoing financial crises. But, as these conditions continually evolve, sophisticated restructuring professionals and advisors continue to innovate, providing the necessary strategic planning and support for finding new and creative ways to restructure gaming businesses and to keep them operating.

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