When Gaming Goes Heads Up with the Bankruptcy Code: Unique Restructuring Issues for Gaming Businesses in Difficult Economic Times[1]

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The intersection of gaming and bankruptcy law has long presented legal conflicts that have never been easily reconciled. This problem has been exacerbated in recent years by the current global and national economic turbulence that has greatly impacted the casino gaming industry and has led to a sizeable increase in the number of businesses using bankruptcy to restructure and/or liquidate assets.[2]

Many institutional investors on Wall Street, as well as private equity firms and large national and international banks, either own equity in, or have lent money to, public and private gaming companies. With creditors anticipating that casino revenues would remain at historically high levels or would continue

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[1] This article is an expansion of a previously published article. *See* Dawn M. Cica, Laury Macauley & Sean M. McGuinness, *In and Out of Bankruptcy: Weathering the Financial Storm in Gaming*, Nev. Gaming Law., Sept. 2011, at 17, *available at* http://www.lrlaw.com/files/Uploads/Documents/Nevada_Gaming_Lawyer.pdf.

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[2] The five-year period between 2006 and 2010 saw business filings nationwide rise almost threefold—in 2006, there were 19,695 filings as compared to 56,282 during fiscal year 2010. Statistical Tables for the Federal Judiciary, Administrative Office of the United States Courts, *available at* http://www.uscourts.gov/Statistics/StatisticalTablesForTheFederalJudiciary.aspx.

to climb, many of these loans were made at the top of the market with high debt leverage ratios. However, because gaming is essentially an entertainment industry, the economic tumult precipitously reduced consumer discretionary spending, leading to deflated casino revenue.[3]

Moreover, businesses in the gaming industry have faced an onslaught of additional competition nationwide. States like California have allowed a substantial expansion of Indian gaming.[4] Moreover, a myriad of states across the nation have expanded authority for gaming enterprises to include, among other things, the addition of traditional casino gaming at racetrack facilities.[5]

As a result of these economic forces and the resulting decrease in discretionary income, casino profitability has suffered and major capital projects have been delayed or shelved. Additionally, many gaming companies have been unable to meet their income or other covenants in their debt obligations. In fact, Nevada's 256 largest casinos netted a loss of nearly $4 billion in the 2011 fiscal year.[6] Faced with such challenges, and the particular conflicts inherent in the gaming and bankruptcy legal constructs, both lenders and debtors in the gaming industry have been forced to develop creative solutions unique to casino businesses, whether in or out of the bankruptcy context.

I. 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 still present numerous difficulties for lenders.

Casinos are typically financed with a combination of secured and unsecured debt much in the same way as any other business. They own property, certain of which they can pledge to secure their debt. Unlike general commercial loans, however, the lender's tripartite relationship to its collateral and the borrower is regulated by state gaming laws. For example, in Nevada, the pledge of privately owned stock in gaming companies requires the prior approval of gaming authorities before they can become effective. A gaming license itself is not subject to encumbrance, since it is considered a revocable privilege to conduct gaming activities.[7] Nevertheless, lenders routinely take the

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[3] American Gaming Ass'n, State of the States: The AGA Survey of Casino Entertainment 5 (2011) (According to the American Gaming Association, total U.S. consumer spending on commercial casino gaming declined in 2008 and 2009, only to rebound slightly with an increase of 0.9% in 2010. In Nevada, the increase was a modest 0.1%.).

[4] *Id.* at 23.

[5] *Id.* at 4 (As of December 31, 2010, there were 456 Tribal casinos nationwide, covering twenty-eight different states; there were forty-five racetrack casinos, covering twelve states.).

[6] Nevada State Gaming Control Board, Nevada Gaming Abstract 2011 (Jan. 6, 2012) (reporting that Nevada's 256 largest casinos generated a net loss of $3,996,656,422.00 in the 2011 fiscal year).

[7] Nev. Rev. Stat. § 463.220(2) (2009) states in part, "No state gaming license may be assigned either in whole or in part;" s*ee also*, Nev. Gaming Reg. 8A.010(4) (regulations of the Nevada Gaming Commission, which defines "personal property gaming collateral" and "operating license" separately).

position that the "enterprise value" of the casino constitutes intangible personal property, allowing them to assert a security interest in that goodwill.[8]

In addition to those regulatory issues, the necessary set-up of a casino business itself presents unique challenges to the lender. One of the most important characteristics of the gaming business is the typically large 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 is represented by chips. Pursuant to the Uniform Commercial Code (UCC), Section 9-313(a), a lender's security interest in that cash can only be perfected by possession.[9] However, because cash is the lynchpin of the gaming enterprise (and casinos need to maintain a minimum bankroll on hand per gaming regulations),[10] a lender's actual possession of such cash (and perfection of its security interest thereby) would prohibit the continual and profitable operation of the casino.

Even if the lender was 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.[11] Although there are no cases that directly address whether the revenue generated by such gaming equipment constitutes "proceeds" under the UCC, it is questionable whether such a position would prevail, because cash neither diminishes the value of the lender's collateral when generated, nor is generated from the sale or transmutation of the collateral.[12] If the revenue does not constitute "proceeds," this is injurious to the secured creditor's interest after a bankruptcy filing, because a security interest does not attach to post-petition revenue unless it constitutes "proceeds, products, offspring, or profits . . . ." of the pre-petition collateral.[13] Furthermore, if an "interest"[14] in this revenue cannot be established, a lender may be helpless to stop a casino from freely using cash on hand, despite the fact that such cash may have been earned through the use of encumbered gaming equipment.

Due to the uncertainty of these various legal 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.[15] As part of this structure, the lender generally requires the borrower to deposit cash into accounts controlled by the lender, which then "waterfalls" out to pay approved operating expenses and debt obligations.

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[8] *See* NEV. REV. STAT. § 463.510(1) (2009).

[9] U.C.C. § 9-313(a) (2001).

[10] *See* Nev. Gaming Comm'n Reg. 6.150 (Mar. 2006) (regulations of the Nevada Gaming Commission).

[11] "Gaming equipment" includes, gaming devices, cashless wagering systems, and associated equipment as defined in NEV. REV. STAT. §§ 463.0155, 463.014, 463.0136 (2009).

[12] *See*, *e.g.*, *In re* S & J Holding Corp., 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984) (cash revenues generated by video game machines and vending machines do not constitute "proceeds").

[13] *See* 11 U.S.C. §552(b)(1) (2006).

[14] *Id.* § 363(a).

[15] As of the July 28, 2009 filing date of the chapter 11 bankruptcy cases of Station Casinos, Inc, all of debtors' real estate was owned by separate entities from that of its operating entities, making for a jointly-administered case of seventeen separate debtors. *See In re* Station Casinos, Inc., No. BK-09-52477, 2010 Bankr. Lexis 5673 (Bankr. D.Nev. 2010).

In addition to the issues that arise in connection with the grant and perfection of a lender's interest in 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, generally requiring application and a finding as to the lender's suitability.[16] 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 and difficult to predict. Certain foreclosures of stock or equity also require prior approval of the lender by the gaming regulatory authorities.[17] Although gaming devices may be foreclosed upon without prior approval from regulators, approvals are required in order to sell or further transfer those gaming devices. When the devices are ultimately transferred, the transfer must be to someone who already holds a manufacturer's or distributor's license.[18] 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. Accordingly, 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.

Increasingly, with the new borrowing structures, lenders are finding ways to restructure without the cost and delay of a bankruptcy filing. Oftentimes, lenders use leverage against personal guarantors to gain negotiating power. For example, the parties to the senior secured loan on the M Resort agreed that, rather than a foreclosure or entering bankruptcy, the parties would market and auction the property.[19] Similarly, the Planet Hollywood lenders and owners agreed to sell the property to Caesars Entertainment, f.k.a. Harrah's Entertainment, rather than filing a chapter 11, which would have constituted yet another

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[16] *See*, e.g., NEV. REV. STAT. §§ 463.160-170 (2009). For example, on December 23, 2011, the Nevada Gaming Commission found Ronald Paul Johnson "suitable" to serve as receiver for the Las Vegas Hilton, including its gaming business, in advance of his appointment by the Court (see more detailed discussion, *infra*). An applicant cannot be found "suitable" unless the Commission is satisfied that the applicant is:

> (a) A person of good character, honesty and integrity;
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> (b) A person whose prior activities, criminal record, if any, reputation, habits and associations do not pose a threat to the public interest of this State or to the effective regulation and control of gaming or charitable lotteries, or create or enhance the dangers of unsuitable, unfair or illegal practices, methods and activities in the conduct of gaming or charitable lotteries or in the carrying on of the business and financial arrangements incidental thereto; and
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> (c) In all other respects qualified to be licensed or found suitable consistently with the declared policy of the State.

Id. § 463.170.

[17] *See* Nev. Gaming Comm'n Reg. 8.010 (2011).

[18] *See*, *e.g.*, NEV. REV. STAT. § 463.162.

[19] *See* Howard Stutz, *M Resort Facing Sale,* LAS VEGAS REV.-J., Aug. 16, 2010, http://www.lvrj.com/business/lloyds-banking-group-soliciting-bids-for-m-resort-100804429.html.

bankruptcy for the former Aladdin property.[20] More recently, the Palms announced that the owners had sold 98% of the equity in a transaction that erased $400 million in debt.[21]

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.[22] 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.[23] 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.[24] The licensure of the casino tenant by the Nevada Gaming Commission occurred at the same hearing in which the lender's temporary waiver was obtained.[25]

In the recent case of the Las Vegas Hilton ("LV Hilton"), the lenders applied to the district court for a receiver under the Nevada statutes.[26] After an evidentiary hearing at which the judge questioned the interplay between gaming and a secured lender's remedies, the district court judge appointed a receiver for the non-gaming properties.[27] The lenders obtained appointment of a receiver who had previously agreed to buy the LV Hilton, and the receiver concurrently filed for a gaming license under N.R.S. § 463.[28] The final order turned the LV Hilton's assets and operations over to the receiver, contingent upon the Nevada Gaming Commission's finding of suitability, which was determined subsequently.[29]

Nevertheless, if the borrower and the lenders cannot agree on a consensual restructuring,[30] borrowers will often file a chapter 11 bankruptcy petition in order to gain negotiating leverage over the lenders. The casino industry is naturally favored in this respect, simply because of the amount of cash it generates

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[20] *Harrah's Moves Ahead with Possible Planet Hollywood Acquisition,* LAS VEGAS SUN, Nov. 30, 2009, http://www.lasvegassun.com/news/2009/nov/30/harrahs-moves-ahead-possible-planet-hollywood-acqu/; *Harrah's Officially Takes Over Planet Hollywood*, LAS VEGAS SUN, Feb. 19, 2010, http://www.lasvegassun.com/news/2010/feb/19/harrahs-officially-takes-over-planet-hollywood/.

[21] Chris Sieroty, *Regulators Recommend Sale of Palms Majority Stake*, LAS VEGAS REV.-J., Nov. 2, 2011, http://www.lvrj.com/business/regulators-recommend-sale-of-palms-majority-stake-133108318.html.

[22] Chris Sieroty, *State Gaming Officials To Discuss Hard Rock Fate*, LAS VEGAS REV.-J., Feb. 4, 2011, http://www.lvrj.com/business/state-gaming-officials-to-discuss-hard-rock-fate-115298134.html.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] Stipulation and Order for the Appointment of a Receiver, Goldman Sachs Mortgage Co. v. Colony Resorts LVH Acquisitions, LLC, No. A-11-648281-B (Nev. Dist. Ct. Jan. 6, 2012) [hereinafter Goldman Sachs Stipulation and Order].

[27] *Id.*

[28] *See, e.g.*, NEV. REV. STAT. § 463.160 (2009).

[29] Goldman Sachs Stipulation and Order, *supra* note 26.

[30] This might also be true if the granting of receivers over gaming properties becomes more accessible to lenders.

and the difficulties lenders face with respect to perfection of their security interests. As they say in the industry, "he who has the cash wins."

Bankruptcy law generally eliminates a lender's ability to obtain new liens post-petition in "after-acquired" property.[31] Instead, a lender may only claim a security interest in property that constitutes "proceeds" of property encumbered pre-petition.[32] To qualify as a "proceed," the property must "necessarily derive[ ] from the sale, exchange or other dispensation of other encumbered property."[33] Stated another way, only property that is directly attributable to pre-petition collateral, without the addition of estate resources, can qualify as proceeds.[34] Courts addressing the general issue of what constitutes proceeds have consistently held that revenue derived from the use of collateral, as opposed to the disposition or diminution of collateral, are not "proceeds."[35]

As a result, once in bankruptcy, casinos generally argue that lenders have no interest in cash generated from the use of encumbered gaming equipment. There are no published opinions directly addressing the issue. Based on decisions that have been issued dealing with types of revenue generated by other kinds of machines, including the Las Vegas Monorail, it appears that it may be more difficult than ever for a lender to rebut such a contention successfully.[36] This point becomes clear by simply examining the day-to-day operations of a casino. Patrons enter casinos with the intention of using the equipment (slot machines, tables, video games, etc.) for the thrill of possibly realizing a big return on their wager. However, no matter how large the wager, no lease or ownership in the inventory or equipment of the casino is intended or expected to be granted to a gambler in exchange for his or her wager.

However, even if a lender could demonstrate that cash generated from gaming equipment qualified as proceeds, the hurdle of commingling would remain. In order to prohibit the use of cash collateral, a lender must demonstrate a legally cognizable interest in the collateral.[37] When an interest is claimed in proceeds, the proceeds must be reasonably identifiable.[38] In other words, "once a debtor deposits cash proceeds into an account and commingles it with other money, the [ability to identify] a secured creditor's proceeds is destroyed unless the secured creditor can prove the money currently in the debtor's account corresponds to its collateral."[39]

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[31] *See* 11 U.S.C. § 552(a) (2006); *In re* Stallings, 290 B.R. 777, 783 (Bankr. D. Idaho 2003).

[32] *See* 11 U.S.C. § 552(b) (2006).

[33] Philip Morris Capital Corp. v. Bering Trader, Inc. (*In re* Bering Trader), 944 F.2d 500, 502 (9th Cir. 1991); *see also,* U.C.C. § 9-102(a)(64) (2001) (defining proceeds as "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral . . . .").

[34] *See* 5 COLLIER ON BANKRUPTCY ¶ 552.02[2][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011); *In re* Delco Oil, Inc., 365 B.R. 246, 249 (Bankr. M.D. Fla. 2007).

[35] *See In re* S & J Holding Corp., 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984); CLC Equip. Co. v. Brewer (*In re* Value-Added Commc'n, Inc.), 139 F.3d 543, 546 (5th Cir. 1998); *In re* Las Vegas Monorail, 429 B.R. 317, 333-34 (Bankr. D. Nev. 2010).

[36] *See In re* Las Vegas Monorail, 429 B.R. at 342-45.

[37] 11 U.S.C. § 363(a).

[38] *See* NEV. REV. STAT. § 104.9315(b) (2009).

[39] Arkinson v. Frontier Asset Mgmt., LLC (*In re* Skagit Pac. Corp.), 316 B.R. 330, 338 (B.A.P. 9th Cir. 2004).

Unlike many other businesses, casinos operate with money cages. Cash, coins, and chips obtained from patrons on the casino floor end up in these cages. Although gambling may account for the majority, this revenue is generated from a variety of sources. As such, difficulty arises with respect to identification of the specific proceeds generated from the use of gaming equipment.

Either way, a casino lender enters the bankruptcy process at a disadvantage. Without an encumbrance on cash collateral, a gaming business can use these funds for the administration of the bankruptcy.[40] This pool of cash, coupled with the fact that most casinos have positive EBITDA,[41] in many cases gives the borrower the leverage it needs over its lenders.

Despite this advantage, most 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, in turn, maximize the return to creditors.

II. Impact of Gaming Issues in Bankruptcies

Increasingly, borrowers and senior lenders may have agreed to restructure the gaming company. However, pursuant to a structure that requires the borrower to file a bankruptcy petition to achieve the terms of the agreement, if there are non-consenting junior creditor groups who have claims that need to be addressed in order to allow the restructured company to have a fresh start and to get through their bankruptcy case quickly. Sometimes this is referred to as a "prepackaged plan" or "prepack," because the borrower and senior lenders agree on the terms of the plan before the case is filed. Such pre-packaged plans were seen in the Station Casinos and Riviera cases, among others.

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. The bankruptcies of casino debtors typically follow three different paths:

1) *Chapter 11 reorganization with a debtor that generates enough cash flow, and/or has significant debtor-in-possession financing*. These two factors will in turn operate to justify the bankruptcy court in allowing the debtor-in-possession to continue operation during the bankruptcy, and to offer a plan of reorganization to its creditors and to the bankruptcy court. Examples of this type of bankruptcy were: Herbst Gaming,[42] Station Casinos,[43] the Riviera,[44] Stratosphere Casino and Hotel,[45] Fitzgeralds Gaming Corporation,[46] and the

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[40] *See* 11 U.S.C. §552(a) (property acquired after commencement of case not covered by pre-petition security agreement).

[41] "EBITDA" stands for "earnings before interest, taxes, depreciation and amortization" and is often used as an indicator of a company's financial performance.

[42] Herbst Gaming, Inc. v. Insurcorp (*In re* Zante, Inc.), No. 3:10-cv-00231, 2010 WL 5477768 (Bankr. D. Nev. Dec. 29, 2010).

[43] *In re* Station Casinos Inc., No. 09-52477, 2011 WL 6813603 (Bankr. D. Nev. Dec. 21, 2011).

[44] *In re* Riviera Holdings Corp., No. 10-22910 (Bankr. D. Nev. 2010).

[45] Mcdonald's Corp. v. Stratosphere Corp. (*In re* Stratosphere Gaming Corp.), 23 F. App'x 749 (9th Cir. 2001).

Aladdin Casino and Hotel.[47] 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 (a) does not generate enough cash flow to continue operations, or (b) does not have adequate debtor-in-possession financing to finance the bankruptcy long enough to complete the required plan of reorganization process*. In this instance, the bankruptcy court may order a sale of the debtor's assets, pursuant to Bankruptcy Code section 363, which results in the property being marketed for sale.[48] In such an instance, a stalking horse bidder may be contracted with to make a minimum, opening bid of the assets at auction.[49] In any event, an auction will usually take place under the bankruptcy court's supervision. In this scenario, the debtor-in-possession's equity owners are able to participate in the auction and bid for the assets alongside non-owners. Examples of this type of bankruptcy were: The Resort at Summerlin,[50] Stateline Casino,[51] and the Siena Hotel Spa & Casino.[52] In the first two instances, the casinos stayed open with the agreement that a sale process would be immediately initiated. In the case of the Siena, the gaming business ran out of sufficient funds to operate under state regulations and voluntarily shut down before the sale was conducted.[53]

3) *Chapter 7 liquidation with a debtor that does not generate positive cash flow, and does not 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 the assets. Examples of this type of bankruptcy were: The Maxim Hotel and Casino[54] and Fitzgeralds Reno.[55]

Regardless of the type of casino bankruptcy, once a bankruptcy petition is filed, the casino operators' fiduciary duties shift from that of equity owners of the company to the bankruptcy estate itself (and more specifically to all of the creditors). Then, the debtor's duties (even if a trustee has not been appointed) become similar to those of a bankruptcy trustee to maximize the eventual distribution to the bankruptcy estate's creditors.[56] The focus then is on allowing the casino's operations to continue so as to maximize revenues in order to make it

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[46] *In re* Fitzgeralds Gaming Corp., No. 00-33467 (Bankr. D. Nev. 2011).
[47] *In re* Aladdin Gaming, LLC., No. 01-20141 (Bankr. D. Nev. 2011).
[48] 11 U.S.C. § 363 (2006).
[49] *See In re* Aladdin Gaming, LLC, No. 01-20141.
[50] *In re* The Resort at Summerlin Inc., No. 00-18878 (Bankr. D. Nev. 2011).
[51] Jorgenson v. State Line Hotel, Inc. (*In re* State Line Hotel, Inc.), 323 B.R. 703 (B.A.P. 9th Cir. 2005), *vacated* 242 F. App'x 460 (9th Cir. 2007).
[52] *In re* High-Five Enter., LLC , No. 10-54013 (Bankr. D. Nev. 2010) (jointly administered with *In re* One South Lake Street, LLC., No. 10-54065 (Bankr. D. Nev. 2010)).
[53] *Id.*
[54] *In re* Max Gaming, LLC., No. 99-19904 (Bankr. D. Nev. 2000).
[55] *In re* Fitzgeralds Reno, No. 00-33469 (Bankr. D. Nev. 2011) (The Reno casino 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.).
[56] 11 U.S.C. § 1107(a) (2006) ("a debtor in possession shall have all the rights, . . . powers, and shall perform all the functions and duties . . . of a trustee . . . ."); *In re* Reliant Energy Channel View LP, 594 F.3d 200, 210 (3d Cir. 2010) ("debtors-in-possession have a fiduciary duty to maximize the value of the estate").

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 becomes worthless, as the equity is last in priority to be paid out under the Bankruptcy Code.[57]

Once the gaming borrower has filed for bankruptcy, the extensive state and local gaming regulatory schemes not only complicate, but are often at odds with the bankruptcy process. Federal bankruptcy law and state and local gaming regulations may present competing goals and requirements. Two goals underlying the federal bankruptcy process are: providing creditors with payment and allowing an ongoing business to emerge rehabilitated. On the other hand, gaming regulations are driven by numerous public policies not at issue in the bankruptcy process. These public policies include: 1) the protection of consumers; 2) the integrity of the gaming industry as a whole; 3) the control of the financial practices of gaming businesses; 4) the prevention of unsuitable persons from involvement in gaming; 5) establishing and maintaining appropriate accounting procedures for gaming enterprises; and 6) maintaining a stable source of revenue for state and municipalities through tax and licensing revenues.[58]

The impact of state regulators upon a gaming bankruptcy is made by its two-pronged regulatory scheme of controlling the businesses through both reporting and licensing requirements. The reporting requirements include the submission of periodic and detailed financing and operating reports, the maintenance of stock ledgers that disclose all beneficial owners, and the reporting and approval of most loans, leases, sales of securities and any other financing transactions of the gaming business.[59] On the other hand, extensive licensing requirements require, among other things, all officers, directors, and certain key employees to apply to be licensed or found "suitable" after comprehensive disclosure and investigation of detailed personal information at the great expense of the applicant.[60] These requirements are not waived or otherwise limited in any way by the filing of the bankruptcy case, because the automatic stay normally given to actions against a debtor in bankruptcy does not apply to the exercise of "police or regulatory power" by a "governmental unit" to enforce a non-monetary judgment.[61]

However, recent Nevada legislation may act to ease the overly burdensome licensing requirements by allowing entities to file applications for a "preliminary finding of suitability" before first being in a position in which licensing is mandatory under the Nevada Gaming Control Act.[62] As a result, a party without an existing involvement in Nevada's gaming industry or an agreement that gives it a right to such involvement, now has the opportunity to apply for a preliminary finding of suitability, thereby providing the party with a

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[57] *Id.* § 1129(b)(2)(B)(ii) (the so-called "Absolute Priority Rule," which requires that all unsecured creditors would need to be paid in full to allow any payment to the equity).

[58] *See* NEV. REV. STAT. § 463.0129 (2009).

[59] *See* Nev. Gaming Comm'n Reg. 8.130 (2)-(3). Additionally, other reporting requirements for licensees are contained in numerous regulation sections.

[60] *See* NEV. REV. STAT. § 463.170.

[61] 11 U.S.C. § 362(b)(4).

[62] *See* NEV. REV. STAT. § 463.1625(1).

means to address and resolve licensing risks prior to entering into a major transaction or assuming an employment position requiring licensing.

III. Procedural Issues in Gaming Bankruptcies

In addition to the all-encompassing policy issues, there are also complicated procedural issues. When a debtor files a chapter 11 petition, 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.[63] This "stay" creates a myriad of problems for a gaming business due to the necessary, constant flow of cash and cash equivalents (vouchers, chips, and tokens) and in light of wagers on future events (as for keno and sporting events in the sports book). This is because one cannot count on them being paid out prior to the filing of the bankruptcy petition due to the nature of a casino's round-the-clock operations.

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—the so-called "first day orders." Although these motions are highly irregular in the bankruptcy process insofar as they request payment of pre-petition, unsecured obligations prior to distribution to other unsecured creditors (normally inviolate in a bankruptcy case), the motions are nonetheless essential to the continuation of the gaming enterprise. They are designed to ensure that the debtor can maintain normal business operations with customers, employees, suppliers, and other stakeholders and continue the necessary generation of revenue and compliance with state gaming laws. 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 "first day orders" allow the debtor to do the following: pay employees, pay certain important trade creditors or "critical vendors," pay taxing authorities, honor room reservations, convention contracts and deposits, use the existing cash management system already in place, retain attorneys and other advisors, use estate assets (including cash) to conduct business operations, and obtain financing to fund the administration of the bankruptcy.[64]

Because these orders are so crucial, gaming debtors normally arrange in advance with the bankruptcy court for a hearing date to occur shortly after the filing of their bankruptcy petition. Moreover, despite the short notice normally given to the creditors of the estate and other parties in interest, the bankruptcy courts routinely grant these motions on an interim basis, and then grant a series of final orders after additional notice time has been given and a continued hearing has occurred.

Gaming authorities may be able to exercise their "police power" to force the casino to honor obligations to its customers made prior to the bankruptcy

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[63] 11 U.S.C. § 362.

[64] *See* Lynn P. Harrison & James V. Drew, *First Day Orders: A Survey of Critical Vendor Motions and Recent Developments*, *in* PLI's Course Handbook, 31st annual Current Development in Bankruptcy & Reorganization (2009), *available at* www.pli.edu/emktg/toolbox/SurVendor_Motions36.doc.

filing and to honor the state and local taxes inherent in the business.[65] The Bankruptcy Code technically requires that, upon filing for bankruptcy protection, a casino is to cease issuing and honoring pre-petition chips and recognize only new "post-petition chips."[66] However, the bankruptcy court's "first day orders" will normally fix this problem and include a grant of 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, honor tour and travel commitments and other pre-petition room deposits, honor customer incentive programs and other agreements like "Megabucks," and pay gaming taxes.

Practically, a debtor casino could not compete in the highly competitive gaming industry if it was required to follow certain requirements of the Bankruptcy Code strictly. 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 and to comply with state gaming regulations the casino must honor each of those pre-petition obligations of the debt post-petition, and do so with no interruption upon the bankruptcy filing. Due to the role of the gaming authorities, in many cases, the debtor will normally 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 in a gaming case. In the bankruptcy context, post-petition financing requires the approval of the bankruptcy court, pursuant to Bankruptcy Code section 364[67] and, once a petition is filed, lenders cannot be compelled to provide further loan advances based on pre-petition financing agreements.[68]

However, because this funding triggers the same kind of regulatory scrutiny as non-bankruptcy funding and is subject to the same constraints,[69] loans to gaming debtors are complex.[70] If a debtor needs financing, the senior

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[65] *See infra* Part III.

[66] Under Nev. Gaming Comm'n Reg. 12.060 of the Nevada Gaming Commission and State Gaming Control Board, chips and tokens constitute debt. In bankruptcy, chip holders are considered general unsecured creditors. Generally, casinos pay chip or token debt with cash reserves inside the gaming establishment. Often, lenders have a security interest in a casino's cash reserves or cash collateral. After the filing of a bankruptcy petition, pursuant to 11 U.S.C. § 363(c)(2)(B), a debtor may not use cash collateral without the creditor's consent or court order. Furthermore, as discussed *supra*, the absolute priority rule (11 U.S.C. §1129(b)(2)(B)(ii)) requires that higher priority creditors be paid in full before lower priority claimants receive any payment. Additionally, the automatic stay established by 11 U.S.C. § 362 prevents creditors from taking any act to collect a pre-petition debt. Taking all these factors together, a debtor casino is technically not supposed to honor pre-petition chips or gambling debts. Nevertheless, casinos usually avoid this restriction by filing first day motions seeking leave of the court to use cash collateral to maintain business operations.

[67] *See* 11 U.S.C. § 364(b)-(d) (2006).

[68] *See id.* § 365(c).

[69] Cash perfection issues, non-assignability of the gaming licenses, and regulatory approvals.

[70] Such financing is often called "DIP" financing or "debtor-in-possession" financing.

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. They may even require an agreement from the debtor as to the validity and extent of their liens against the debtor's property and require that the debtor give up claims against the lenders.

Unfortunately, this cooperation between the debtor and the senior secured lender may not be enough to ensure liens remain unchallenged or that claims will not eventually be pursued. A debtor in possession ("DIP") has all the rights and powers of a trustee, including the ability to avoid certain liens encumbering estate property.[71] However, if a debtor in possession neglects to take such action, courts can confer derivative standing upon a third party—assuming certain criteria can be demonstrated[72]—to bring actions to recover property for the benefit of the estate.[73]

A recent Delaware decision illustrates how derivative standing may arise in a case involving a debtor that is a gaming entity.[74] In *In re Centaur, LLC*, the Official Committee of Unsecured Creditors sought derivative standing to challenge the validity of various liens held by the senior secured lenders and the second lien holders.[75] The debtor was a holding company for a variety of entities operating gaming facilities in several states.[76] Among other things, the Committee challenged the senior secured lenders' perfection in "cage cash" at off-track betting locations operated by the debtor's affiliates.[77] Additionally, the Committee sought to avoid as fraudulent transfers certain liens associated with "upstream guaranties" from the affiliated gaming entities regarding the senior secured credit facility.[78] Overall, the Committee sought to avoid liens on estate property worth an estimated $192 million.[79]

As the primary basis for bringing its motion, the Committee contended that the debtor unjustifiably refused to bring these actions on behalf of the estate.[80] In support of this contention, the Committee offered expert testimony that identified a potential recovery for the unsecured creditors of over $85 million, if certain liens were avoided.[81] To rebut this, the debtor offered testimony that only $6.55 million would be recovered—just $1.55 million above the high end estimated litigation costs to pursue the claims.[82] Despite these disparities in

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[71] *See supra* Part III.
[72] *In re* YES! Entm't Corp., 316 B.R. 141, 145 (Bankr. D. Del. 2004) (stating that derivative standing requires: "(1) a colorable claim, (2) that the trustee unjustifiably refused to pursue the claim, and (3) the permission of the bankruptcy court to initiate the action.").
[73] *See* Fogel v. Zell, 221 F.3d 955 (7th Cir. 2000); Commodore Int'l Ltd. v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96 (2d Cir. 2001); Official Comm. Of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir. 2003); *In re YES! Entm't Corp.*, 316 B.R. at 141; *In re* Centaur, LLC., No. 10-10799, 2010 WL 4624910 (Bankr. D. Del. Nov. 5, 2010).
[74] *In re Centaur,* 2010 WL 4624910, at *1.
[75] *Id.*
[76] *Id.* at *1-2.
[77] *Id.* at *4.
[78] *Id.*
[79] *Id.* at *1.
[80] *Id.* at *5-7.
[81] *Id.* at *5.
[82] *Id.* at *5-6.

value, the *Centaur* court granted derivative standing to the Committee.[83] In reaching this determination, the court concluded:

> Under these circumstances, and understanding there may indeed be some benefit to the estate [itself] if some or all of the claims are prosecuted successfully, and to achieve the appropriate balance between allowing pursuit of colorable Claims and ensuring benefit to the estate, [the court] will grant the Committee's request for standing to prosecute the Claims . . . .[84]

Thus, as *Centaur* demonstrates, even if a debtor agrees to the validity of certain liens or the forfeiture of certain claims to obtain DIP financing, such agreements can still be challenged by other parties in interest in the case. Although these agreements benefit a debtor by allowing it to continue its operations, a strong argument exists that the forfeiture of such claims potentially harms other creditors by minimizing the bankruptcy estate. As expected, the greater the magnitude of the claim a debtor waives, the more likely a third party may be granted derivative standing to pursue the potential benefit for the estate.

Although derivative standing presents a potential difficulty in a casino reorganization, other obstacles are more certain. Like all casino financing, DIP financing requires the licensees to provide the appropriate notices to the gaming authorities.[85] 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, notwithstanding prior approval by the bankruptcy court.[86] However, in many bankruptcies, additional DIP financing is not needed because the debtor's operations still generate sufficient revenues to support its operations. Nevertheless, in such a case, there may still be negotiations over the definition and use of the lender's cash collateral, as both are instrumental to the success of the debtor's reorganization.

Additionally, and of key importance to a debtor, once the case is ongoing, the debtor has the ability to accept, assume, and assign, or reject executory contracts. Although the Bankruptcy Code does not define an "executory contract," the legislative history of section 365 adopts the Countryman[87] definition of such contracts as those "on which performance remains due to some extent on both sides."[88] In the context of a gaming business, executory contracts would include leases of gaming devices such as slot and video poker machines.

However, it must be noted that this key ability to accept or reject contracts in bankruptcy is limited by gaming regulations, which may impact the timing of any proposed assignment, as well as limiting the group of persons or entities to which those contracts are assigned.

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[83] *Id.* at *7.

[84] *Id.*

[85] *See* Nev. Gaming Comm'n Reg. 8.130 (2011).

[86] *See generally* NEV. REV. STAT. § 463 (2009).

[87] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 447 (1973); 3 COLLIER ON BANKRUPTCY, *supra* note 34, at ¶ 365.02[1].

[88] 3 COLLIER ON BANKRUPTCY, *supra* note 34, at ¶ 365.02[1].

IV. Exit Strategies

The goal of every bankruptcy debtor is to exit from bankruptcy. During a chapter 11 case the debtor will propose a plan of reorganization based on its negotiations with creditors in order to accomplish that exit. 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, a "friendly foreclosure" 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.[89] 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.[90] Thus, the debtor's ability to obtain the bankruptcy court's approval of its plan of reorganization 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).[91] 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.[92]

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.[93] An asset sale may be very beneficial to a creditor who is either unwilling or unable to undergo the licensing or suitability scrutiny 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.

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[89] Nev. Rev. Stat. §§ 463.165, 463.167 (2009).

[90] *See id.* § 463.165.

[91] *See* 11 U.S.C. § 1126(c) (2006).

[92] Nev. Gaming Comm'n Reg. 8.030 requires any new owner to obtain licensing from the Commission.

[93] 11 U.S.C. § 363; Nev. Gaming Comm'n Reg. 8.030 (1975).

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. 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.[94]

In regard 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, thus 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.

V. Going Forward

Despite some slow growth in casino revenues over the last several years, the effects of the current economic climate are significant, from credit tightening to unemployment, and 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 still face the challenges posed by the ongoing financial crises and the difficulties that the necessary intersection between gaming regulations and bankruptcy statutes presents. 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 in accordance with state and federal laws, and to keep them operating.

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[94] *See* Nev. Rev. Stat. § 463.160(1)(d).