Lake of Torches Appellate Decision: "Management Contracts" Are Still a Burning Issue in Tribal Gaming Financings

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Earlier this week, the United States Court of Appeals for the Seventh Circuit upheld the *Lake of Torches* decision that invalidated a bond indenture as a "management contract" because it contained provisions that permitted lenders to influence the management of a tribal casino without National Indian Gaming Commission (NIGC) approval of such bond indenture. But the court also reversed the lower court's decision to block the indenture trustee from seeking recovery on legal and equitable claims that may arise under the sovereign immunity waivers in other financing documents related to the indenture. Although the decision provides some important guidance for lending to tribal casinos, it does very little to ameliorate the uncertainty in tribal casino financing affecting the capital markets since the original district court decision in the *Lake of Torches* case. A copy of the appellate decision can be found here.

Background

The Lac du Flambeau Band of Lake Superior Chippewa Indians (the "Tribe") financed the development of the Lake of Torches Resort Casino and related gaming investments (collectively, the "Casino") by borrowing $50 million from investors represented by Wells Fargo as indenture trustee (the "Trustee"). The financing was memorialized through an indenture (the "Indenture") and additional customary documents including promissory notes, tribal resolutions and collateral documents (the "Additional Documents").

The financing was collateralized by, among other things, a lien on a collection account. The Indenture obligated the Tribe to deposit all gross gaming revenues generated by the Casino into the collection account. Disbursements from the collection account were made to the Tribe to fund casino operating expenses and to pay interest and principal on the bonds.

The Casino did not perform as expected and the Tribe defaulted on its repayment obligations with the $50 million principal balance still outstanding. In addition, the Tribe ceased depositing Casino revenues into the collection account and diverted Casino revenues away from its lenders.

Soon thereafter, the Trustee brought an action in federal district court to enforce the Indenture and requested the appointment of a receiver to oversee the collateral (predominantly the Casino's cash flows).

The district court dismissed the Trustee's action because it ruled that several provisions in the Indenture rendered it a "management contract" under the Indian Gaming Regulatory Act (IGRA) and the Indenture was therefore void *ab initio* because it had not been approved by the NIGC. The district court refused to sever the offensive provisions of the Indenture and permit the balance of the Indenture to stand (most importantly the waiver of sovereign immunity and the obligation of repayment). Instead, it ruled that the Indenture was void and unenforceable in its entirety. This meant that even the sovereign immunity waiver in the Indenture was not enforceable and, without such a waiver, the Tribe was immune from legal action by the Trustee to collect nearly $50 million of outstanding principal.

In addition, the district court rejected the Trustee's alternative argument that, even if the Indenture was unenforceable, the Trustee could still seek recovery under the sovereign immunity waivers in the Additional Documents. According to the district court, all documents related to the Indenture were part of a single transaction and therefore all documents were void, including the sovereign immunity waivers in such Additional Documents.

The district court's decision left the Trustee with no ability so seek recovery from the Tribe on the $50 million investment and sent a shockwave through the investment community that has financed hundreds of tribal casinos across the United States.

The Appellate Decision

On appeal, the Seventh Circuit agreed that the Indenture was a "management contract" and was void in its entirety. The Court determined that the following provisions of the Indenture were problematic.

- **Collection Account Mechanic** – the Indenture required the casino's gross revenues to be placed in a collection account over which the Trustee had ultimate control, including the authority to release funds to pay the Casino's operating expenses. The Court determined that such a mechanic "bestows a great deal of authority in an entity other than the Tribe to control the Casino's operations."

- **CAPEX Limitations** – the Indenture prohibited capital expenditures for the Casino in excess of 25% of the previous year's capital expenditures without consent of a majority of the bondholders. The Court determined that bondholders' ability to control the Tribe's spending to improve the Casino was "a major prerogative in determining the present and future direction" of the Casino.

- **Independent Management Consultant** – if certain financial metrics were not satisfied, the Tribe was required to retain an independent management consultant (who had to be approved by the bondholders) and further was required to "use its best efforts to implement [the consultant's] recommendations." The Court determined that this provision "effectively [permitted the bondholders] to direct the operations of the Casino and thereby [transferred] management responsibility over the gaming operations into the hands of a party other than the Tribe."

- **Limitations on Management Changes** – the Indenture forbade the removal or replacement (for any reason) of the Casino's general manager, controller, chairman or executive director of gaming operations without majority bondholder consent. The Court determined that this provision gave bondholders "truly powerful authority over management of the [Casino]" by "tying the hands of the Tribe to replace key officers even when sound management or even regulatory compliance concerns require their removal."

- **Bondholder Ability to Force Management Change** – bondholders could require the Tribe to hire new management of the bondholders' choosing under certain circumstances. The Court determined that such a right provided bondholders "very significant management authority."

While the Court did not attempt to delineate specific guidelines for assessing which creditor rights in an indenture or credit agreement rise to the level of a "management contract" – and even noted, with seeming frustration, that the NIGC "should undertake that task at some point in order to give the entities that it regulates more certain guidance as to the permissible scope of financing agreements" and that "[u]nfortunately, we must resign ourselves to the fact that we do not have the definitive guidance from the [NIGC] that Congress had anticipated" – the Court nonetheless held that the bondholder rights in the Indenture crossed the line and rendered the Indenture void in its entirety.

Notably, the Court did not rule on the provision of the Indenture that permitted the bondholders to seek appointment of a receiver, which figured prominently as a basis for the district court's decision. Instead, the Court ruled that the rights noted above were sufficient to affirm the district court's decision and noted that the appointment of a receiver raised further, complicated issues of reconciling IGRA with other federal procedural rules and traditions of federal equity practice that permit the appointment of receivers.

Finally, the Court reversed the district court's decision to preclude the Trustee from seeking recovery under the Additional Documents, which contained waivers of sovereign immunity independent from the Indenture. The Court remanded the issue to the district court for further proceedings regarding the Trustee's ability to amend its complaint to assert legal and equitable claims under the Additional Documents, thereby preserving a potential action to seek repayment of the $50 million loan under an alternative theory not involving the Indenture. However, the Court also questioned the Trustee's standing to assert such claims suggesting that, with a void indenture, the bondholder investor might have to assert the claims directly rather than through the Trustee.

Takeaways

The decision is a stark reminder of some of the risks involved in financing tribal casinos. Indenture provisions that would be non-controversial (or even standard) in a non-tribal corporate financing not only failed to protect lenders but may, ironically, render the loan unrecoverable.

Restrictions on capital expenditures and the right to appoint a receiver to protect collateral are neither new nor sinister provisions. Nor is it unusual to use a collection account to perfect and protect secured lender rights when financing a cash flow business. To the contrary, these are typical security arrangements designed to encourage lending and provide access to capital necessary for such businesses to survive and flourish.

As the Court noted in its decision, IGRA was enacted to promote tribal economies by providing them with the opportunity to build and operate casinos and to protect tribes from predatory and criminal forces that sometimes influence such businesses. Nevertheless, the application of IGRA to invalidate clearly non-predatory lending arrangements may significantly hinder tribes from accessing capital markets necessary to finance new gaming operations and expansions or refinance existing casino debt.

IGRA’s goal of ensuring that tribal casinos are owned and operated by tribes is clear. Its application to contracts clearly intended to create a management relationship with a tribe regarding a casino operation is also clear. What remains unclear is how Congress ever intended IGRA to be interpreted to somehow treat standard, arm's length commercial lending transactions as contracts for the "management" of a casino. As the Court noted repeatedly in its decision, further guidance regarding the "rules of the road" for tribal casino financings must be provided by Congress and/or the NIGC. It is not in the interest of tribes or their lenders for uncertainty to persist.

In the meantime, lenders are well advised to carefully consider their tribal gaming finance documents to avoid the pitfalls that befell Lac du Flambeau bondholders. Provisions concerning capital expenditures and operating expenses must be carefully crafted to assure that they will not be deemed to constitute management activities under *Lake of Torches*. And other rights, such as the authority to select or replace specific casino managers should be avoided altogether. Until regulatory authorities provide clearer guidance for tribal gaming financings, lenders should also submit new financings/refinancings and restructuring documents to the NIGC for a declination letter stating that the documents do not, in the view of the NIGC, constitute a "management contract." While such a declination letter is not binding on a court in a subsequent legal dispute and therefore cannot render any financing ironclad, it is the most authoritative protection currently available other than seeking NIGC approval as a casino manager—or not lending at all.

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