The Deal
For buyers, tribal casino debt remains the Wild West
By Lisa Allen
31 January 2014

Foxwoods Resort Casino and the Mohegan Sun Casino are about an hour away from each other in Connecticut's interior, but that proximity belies just how different they are in the world of tribal debt restructurings.

For Ledyard, Conn.-based Foxwoods, 2013 was a triumphant year. The Mashantucket Pequot Tribal Nation completed its four-year restructuring of $2.3 billion in debt in July, a deal dubbed the most complex tribal debt restructuring in history.

For Mohegan Sun, however, 2013 was quiet. A Wall Street darling because of its financial transparency and an openness with analysts, the Uncasville, Conn., gaming complex restructured $1.6 billion in debt in February 2012 in a debt exchange that sources described as a creditor-friendly initiative to extend maturities without imposing losses.

Now the Mohegan Tribe of Indians of Connecticut is seeking a new loan package to refinance its bank debt while it also explores diversifying its operations.

"Mohegan said, 'Come hell or high water, we're paying you guys,' " said one hedge fund investor who participated in Mohegan Sun's restructuring in 2012 and Foxwoods' last year and was struck by the sharp differences between the two. "Foxwoods — at the same time — their council members said, 'We're going to cram Wall Street down and take care of our tribal members.' If you look at those two tribes and the solutions they've come to, it's totally different."

Tribal gaming brought in a record $27.9 billion in revenue in 2012, according to the National Indian Gaming Commission, so it attracts its fair share of debt investors. But because federally recognized Native American tribes are sovereign nations just like the United States and France, they can't issue equity, sell tribal assets, file for bankruptcy or get sued.

Those factors provide little recourse for buyers of tribal gaming debt, thus creating uncertainty around casino-related bonds and the restructurings engineered by their issuers. "There are a lot of unknowns," the hedge fund investor asserted. "It's still developing."

The restructuring of River Rock Casino's debt by the Dry Creek Rancheria Band of Pomo Indians in 2011, Mohegan Sun's revamp in 2012 plus the retoolings by Foxwoods and the Paradise Casino and Quechan Casino Resort by the Quechan Tribe of the Fort Yuma Indian Reservation last year have provided distressed-debt buyers with both solace and evidence that workout solutions can be found.

"Now that there have been some successful restructurings, there is some confidence that tribes are not going to repudiate their debt," said Randolph DelFranco, a partner at Holland & Knight LLP who specializes in tribal law. "You're seeing opportunistic hedge funds look at tribal debt."

NOT EVERYONE, however, is willing to take the plunge just yet, even given the premium that DelFranco said the tribes must pay for capital "because of the regulatory issues associated with them."

"Puerto Rico pays its bills. Indian country doesn't," groused one investor who specializes in high-yield and municipal debt. He asked to remain unnamed. He participated in a tribal casino debt deal that went south. "I'd never buy an Indian credit again."

To be sure, there were some ill-fated debt restructurings last year that likely would give such investors pause. For example, a leadership struggle prevented the Picayune Rancheria of the Chukchansi of California from paying its bondholders, culminating in ongoing litigation — and reminding investors of the political risks that can accompany tribal debt investments.

Moreover, the unpredictability doesn't just lie with the tribes or casinos themselves. The Shingle Springs Band of Miwok Indians' refinancing of $505 million in debt last year inspired California to take a surprisingly aggressive stance when it amended its gaming compact with the tribe, providing concessions only if bondholders and other parties would take cuts as well.

As with so many things, the Great Recession changed reality for tribal issuers. The first defaults by tribal issuers with major gaming debt occurred in 2009, and only a handful of tribes have restructured debt since then.

"Before the recession, there were no Native American gaming bond defaults, so there were no precedents or case studies to look at," said Fitch Ratings Inc. analyst Michael Paladino.

The Pueblo of Mescalero Apache tribe, which operates the Inn of the Mountain Gods Resort & Casino in Mescalero, N.M., was the first tribe to default on high-yield debt when, in June 2009, it skipped an interest payment on $200 million in 12% notes due 2010. The tribe, in a November 2010 exchange, swapped every $1,000 in principal for $300 of an 8.75% senior note due in 2020 and $675 of a pay-in-kind notes accruing interest at 1.75% until the other notes are repaid. Fitch estimates that holders will recover 71% of the net present value of their securities.

Just a month after the Inn of the Mountain Gods' default, the Pueblo of Pojoaque tribe's Buffalo Thunder Resort & Casino in Santa Fe, N.M., in July 2009 defaulted on $245 million in 9.375% notes due 2014.

Like the Pueblo of Mescalero Apache, the Pueblo of Pojoaque tried a November 2010 restructuring. But it tried something more creative: it said it would give Buffalo Thunder investors new senior secured notes and unsecured subordinated claim certificates during the first quarter of 2014, with terms to be based on the casino's financial performance in 2012 and 2013. If the casino's performance improves, investors may be rewarded for their trouble.

"It could be considered an equity-like restructuring due to the resetting of the terms," Paladino explained.

But the debt has already attracted a dubious nickname, "hope notes," said one source.

Completing a busy fall of 2010 was the Little Traverse Bay Band of Odawa Indians, which defaulted in September 2009 and then restructured its $122 million in 10.25% senior notes due 2014 through an exchange offer on November 2010. Bondholders exchanged their notes and unpaid interest for $23 million in cash and $40 million in new senior secured notes due 2020. According to Fitch's estimation, investors in the Odawa Casino in Petoskey, Mich., recovered only 45% of the net present value of their bonds.

THE TRIBES HAVE LEARNED a thing or two since those early restructurings, namely that a financial fix isn't enough. More tribes now are incorporating business diversification into their restructuring strategies.

For instance, when the Dry Creek Rancheria Band of Pomo Indians failed to refinance its $200 million in 9.75% senior notes by the Nov. 1, 2011, maturity date, the tribe, which operates its River Rock Casino in Northern California's wine country, supplemented a December 2011 debt exchange with the acquisition of a vineyard operated by a contract grape grower.

The tribe is obligated to send 90% of the cash flow from the vineyard to bondholders. "Their Cab[ernet] is unbelievable," said Holland & Knight's DelFranco, who advised the tribe on its restructuring.

The tribes that run Foxwoods and Mohegan Sun in Connecticut are also working to diversify their operations. Both are opening shopping malls to complement their gaming and hotel operations, which will be facing increased competition from casino projects that are slated to come online in Massachusetts and New York, as well as new properties in Pennsylvania.

Clearly, the Mashantucket Pequot Tribal Nation doesn't want to go through a massive debt restructuring again. Some 99% of bondholders eventually voted in favor of its restructuring plan, eliminating $550 million in debt and pushing back debt maturity dates. But to get there, creditors in Foxwoods' complicated capital structure spent four years in acrimonious negotiations.

Since tribal debt restructurings must be completed outside of court, without a bankruptcy judge or even the threat of a bankruptcy judge to force a resolution, the different creditor classes had to reach a consensual solution.

In order to get junior creditors on board, the tribe's advisers created special debt instruments that would yield a better payout if the casino's performance improves.

Like Buffalo Thunder's proposed new notes, Foxwoods' securities have the potential to reward holders in a way that nods to equity without crossing the verboten line.

The two classes of noteholders with the lowest priority, holding 8.5% notes due 2015 and Subordinated Special Revenue Obligation bonds, took a haircut, but they received these special debt instruments as a consolation prize.

One new security is the "contingent interest obligation," structured so that, if the casino performs well in the future, junior creditors will receive a payout to help compensate for their restructuring losses.

The other innovation is a bond that toggles between cash-pay and pay-in-kind depending on how the business is performing, not at the issuer's discretion. This structure provides the issuer with flexibility in case the business hits a rough spot, but also ensures payouts for creditors if it's doing well.

The flexible securities issued by Foxwoods may provide a model for restructurings to come.

Tribal casinos just may need that larger toolbox, now that states with tough gaming laws are getting wise to the revenues that are bleeding out to casinos in other states. The result has been a "nuclear proliferation" of gaming capacity, according to Jeff Heimann, one of the founders of Tribal Financial Advisors Inc., a boutique investment bank that caters to Native American tribes' financing needs. "There continues to be greater competition, whether it's through expansion on a state-by-state basis or through online gaming or a new tribe or jurisdiction opening up [new facilities]," he explained.

TRIBES WOULD BE BETTER off following the creative financing and diversification paths blazed by others because they aren't likely to get much restructuring help from the courts. In fact, one legal case involving a 2009 default on tribal casino debt is still being litigated.

The Lac du Flambeau Band of Superior Chippewa, which owns the Lake of the Torches casino in Lac du Flambeau, Wis., defaulted on $46.6 million in 12% bonds from distressed private equity firm Saybrook Capital LLC in 2009. The tribe argued that it shouldn't have to pay the debt because its bond indenture with Saybrook was an improper management contract.

When Judge Rudolph T. Randa of the U.S. District Court for the Western District of Wisconsin decided in 2010 that the bond indenture was a management contract that had not been approved by the proper authorities, he frightened tribal credit investors everywhere.

Now investors protect against similar claims by having their bond indentures pre-approved by the National Indian Gaming Commission, a federal agency that regulates tribes' gaming operations. That agency has the power to impose sanctions on tribes that violate the terms established by the 1988 Indian Gaming Regulatory Act.

Moreover, the Lake of the Torches ruling hasn't gained traction as a precedent. Two tribes have tried to use the ruling in the Lake of the Torches case but failed.

The U.S. District Court for the Eastern District of Wisconsin decided in April 2011 that the Sokaogon Chippewa Community couldn't invalidate its debt agreement, since the indenture didn't constitute a management contract. The tribe had waived its sovereign immunity under the indenture for about $20 million in debt, and the court ruled that it still had to fulfill its obligations to trustee Wells Fargo NA.

Wells Fargo also won a case against the Cabazon Band of Mission Indians in October after that tribe tried to use the Lake of the Torches precedent to argue that it shouldn't honor the $62 million it owed on a parking garage at its Fantasy Springs Casino & Resort in California.

Sometimes, the sticking points in tribal credit fights don't have anything to do with financing terms or legalities. Like in other out-of-court restructurings in other industries, there are power struggles within management, or between creditors.

The Picayune Rancheria of Chukchansi Indians, which owns the Chukchansi Gold Resort & Casino in Coarsegold, Calif., shocked the investment community with its persistent political in-fighting.

Chukchansi restructured its $200 million in 8% senior notes due 2013 and $110 million in floating-rate senior notes due 2012 in December 2011 after skipping an interest payment the previous month. But last March, investors' hearts skipped a beat when the tribe missed an $11.93 million interest payment on its $244 million in restructured senior notes due 2020.

The casino was bringing in plenty of cash, so what was the problem? The money was tied up in a struggle between rivals vying for control of the tribal council and languished in a frozen bank account.

Finally, a court ruling laid out a method for transferring the money to the bondholders. Still, the tribe only made part of its Sept. 30 interest payment, While it said it expects to complete the payment once it can access a frozen bank account, the issue has yet to be totally resolved.

Another California facility, the Red Hawk Casino in Placerville, counts the state among its creditors. But when the casino's owner, the Shingle Springs Band of Miwok Indians, reached an agreement to cut debt service costs by refinancing $505 million in debt, it was California that turned out to be the lone holdout.

The state agreed to reduce its share of the casino's revenue to only 15% instead of 20%, but at a price. It demanded that other creditors make concessions, too. The amended gaming compact with the state was specific enough to order the tribe to "reduce [its] existing debt related to the Gaming Facility through refinancing of the existing Senior Notes owed to certain bondholders that are due in 2015."

MORE RESTRUCTURINGS lie ahead for tribal casinos. Ratings agencies are handicapping that Paragon Resort Casino in Marksville, La., and the Snoqualmie Casino outside Seattle could be among them. The interesting question is whether future restructurings will borrow from past efforts or take novel approaches. And that's what continues to worry some bond investors. "It's still the Wild West out there," said one. The Tunica-Biloxi Tribe runs the Paragon Resort Casino in Louisiana, and Fitch Ratings listed Tunica-Biloxi as having one of the highest default risks among U.S. casino operators, alongside Chukchansi, Caesars Entertainment Corp., and Riviera Holdings Corp., in a Sept. 4 report.

Moody's Investors Service concurred. The ratings agency lowered the Tunica-Biloxi Gaming Authority's rating to Caa2 from B3 on Sept. 10.

Two casinos have opened within 90 miles of Paragon, taking away some of its business, as evidenced by the casino's 17% drop in Ebitda for the year ended June 30. Moody's said it fears that the casino's Ebitda may fall below the $35 million threshold required under the tribe's revolving credit facility.

Another likely restructuring candidate is the Snoqualmie Indian Tribe. Moody's downgraded the Snoqualmie Entertainment Authority, which issues debt for the Snoqualmie Casino near Seattle, to Caa1 from B3 on April 8.

Moody's is concerned that the Snoqualmie Indian Tribe may not have enough liquidity to pay off its $130 million in senior floating-rate notes when they mature on Feb. 1.

Given the concerns about heightened competition in the gaming industry, some deals are falling apart. The Buena Vista Rancheria of Me-Wuk Indians pulled a proposed $220 million bond offering that would have backed a new casino in Amador County, Calif., in June.

Moody's had given the tribe's bond-issuing entity a Caa2 rating in April based on concerns about competition in the area, and also the tribe's lack of gaming experience.

"Some of the more traditional investors are saying, 'until I get rid of my Foxwoods paper, until [new gaming capacity in] Massachusetts comes online, I'm not investing more here [in tribal credits]," one source said.

Joseph Kalt, a professor at Harvard's Kennedy School of Government who researches American Indian economic development, is incredulous at the newbie investors who flee at the first sign of trouble.

"You find some investors that get burned once in Indian country and get out forever," he said, comparing such a situation to someone losing money in Greece's debt restructuring and then swearing off all future investments throughout Europe.

Kalt wishes more investors would treat tribes like the sovereign nations they are. "Potential investors tend to lump American Indian tribes into the same boat," he griped. "All other countries are not Egypt right now; investments in Great Britain are doing much better."

Kalt stressed a point that is practically the mantra of experienced investors in tribal credits: The key to investing in Indian country is understanding the specific tribe you're dealing with.

Investors should pay special attention to the term limits, turnover rates, and term staggering in the relevant tribal council, Kalt explained. Tribes with stable governance, strong court systems, and modernized constitutions perform much better than tribes that lack those civic foundations, he added. Political stability underpins economic soundness.

Dana Fusaris, a managing director and co-founder at alternative investment firm Fundamental Advisors LP, which has invested in the bonds of Foxwoods and other tribal casinos, shares Kalt's view that investors must get to know the tribal issuers they are working with.

"This is a space where long-standing relationships of trust are valued," she said. "We have always been familiar with tribal gaming, but started sharpening our pencils when we anticipated that there would be distress in the space."