

**PUTTING IT ALL ON BLACK AND OTHER STRATEGIES  
FOR CASINO REORGANIZATIONS**

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## I. FIRST DAY ORDERS AND DOCTRINE OF NECESSITY

Hotel Casino reorganizations inevitably require first day orders (1) of the type common to all business reorganizations; (2) of the type common to hotel and entertainment, businesses in general; (3) unique to the gaming industry. Typical first day orders shall become commonplace in any business reorganization are applications to pay prepetition, payroll and honor employee benefits; applications for employment (in many cases, interim compensation) of professionals; applications to approve cash management systems; application to omit notice; and in the case of multiple debtors, applications for administrative consolidation. Motions to the degree appropriate to the hotel and hospitality industries include application to honor prepetition, reservations, and deposits; applications to assume or reject entertainment contracts; applications to honor promotional benefits. Applications which are unique in the gaming industry include, first and foremost, applications to honor prepetition, chips, tokens, and wagers. Such applications are routinely and universally granted, notwithstanding the nature of such obligations as the clear prepetition obligation. A player who purchases gaming tokens prepetition holds an unsecured obligation which the casino honors by redeeming the gaming chips (or such larger or fewer number, as the player holds at the time of redemption) for cash. Similarly, a sports book wager represents a prepetition obligation to pay certain amount of money depended upon the outcome of future bets. At the time of bankruptcy, customers will hold sports book wagers for events which have occurred, and for events which have not yet occurred (in which case the obligation of payment is contingent upon the player winning). At the moment of filing, it will be unknown whether unsecured creditors will be paid, the timing of such payment, and whether such

payment will be in full. However, players holding chips, tokens, and wager obligations are, without exception, omitted to exchange these obligations for cash pursuant to orders of the bankruptcy court. Bankruptcy judges considering these issues in the context of gaming reorganizations recognize that, absent honoring such obligations, customers would lose faith in the integrity of the gaming establishment, and business would likely be unable to continue. In addition, failure to honor such obligations could invoke regulatory action which could also endanger operations. While, Debtors typically cite Section 105 as the “court caught all” basis for applications to honor gaming obligations, the legal theory behind such applications must be the “Doctrine of Necessity.” Such a Doctrine has been recognized in various contexts. The Ninth Circuit has twice recognized the Doctrine as supporting the right to payment of Chapter 7 debtor’s bankruptcy counsel, notwithstanding the argument that such an obligation, like all others in bankruptcy, is discharged upon filing of the petition. See In re Hines, 147 F.3d 1185, 1191 (9<sup>th</sup> Cir.1998); In re Sanchez, 241 F.3d 1148, 1150 (9<sup>th</sup> Cir.2001). In rejecting such a position, the Bankruptcy Court W.D. Michigan in In re Chandler, 292 B.R. 583, 588 (Bankr.W.D.Mich 2003) stated:

The Doctrine of Necessity is inapplicable. That Doctrine is a rule of payment that allows trustees to pay prepetition debts in order to obtain continued supplies or services essential to a debtor’s reorganization. The Doctrine itself is a violation of 11 U.S.C. § 507 and in fact, is not authorized by any Bankruptcy Code section. When it has been applied, it allows payment in a Chapter 11 case under very extraordinary circumstances of a few critical vendors who furnish the debtor with unique and vital supplies so that the debtor can operate and reorganize.

“The Doctrine of Necessity stands for the proposition that a bankruptcy court may allow payment outside of a plan of reorganization on account of prepetition obligation

where such payment is critical to the reorganization process.” In re Enron Corp., 2003 WL 1562202, p.16 n.31 (March 21, 2003) (Bankr.S.D.N.Y.)

“The so called ‘Doctrine of Necessity’ or ‘necessity of payment rule’ permits bankruptcy courts in limited circumstances to authorize payment of prepetition claims ‘if such payment [is] essential to the continued operation of the debtor.’” In re Babcock & Wilcox Company, 274 B.R. 230, 256 n.208 (Bankr.E.D.La.2002) citing NextWave Personal Communications Inc. v F.C.C., 254 F.3d 130, 136 (D.C.Cir.2001), citing, In re Just For Feet, Inc., 242 B.R. 821, 825 (D.Del.1999); In re Boston and Maine Corp., 634 F.2d 1359, 1376 (1<sup>st</sup> Cir.1980); In re Equalnet Communications Corp., 258 B.R. 368 (Bankr.S.D.Tex.2000).

Implication of the Doctrine of Necessity typically arises in a context promotion for payment of critical vendors. Such applications have met with varying degrees of success depending upon the court, the circumstances, and the scope of such motions.

Courts have also considered the Doctrine in other contexts. In re Equalnet Communications Corp., 258 B.R. 368 (Bankr.S.D.Tex.2000), the debtor requested authority to pay a prepetition contractor and to adjust customer bills for prepetition credit. The court granted the applications to a limited extent. The court cited examples in which courts in that district had prevented payment of prepetition claims prior to the confirmation. First, in certain circumstances, turnover of cash collateral would be permitted. Second, in a case involving an assumption of an executory contract, the cure of past due would be allowed as the proper and inevitable administrative expense. Third:

[C]ertain cases involve business transactions which are at once individually minute but collectively immense and critical to the survival of the business of the debtor. Examples include the redemption of prepetition retail coupons in a consumer products

case, the honoring of credit card debits, credits and chargebacks in a retail department store case or, as in the case at bar, the issuance of billing credits to retail customers in connection with prepetition telephone services and invoices. The impact of the failure to allow payment of these sorts of “nuisance” items would be devastating to a proposed reorganization in the context of a retail market. A quick corollary is that such a failure to pay and its consequent loss of customer base would impair value of the business on either a going concern or liquidation basis. Further, the prepetition claims in some cases might be subject to offset or recoupment or both. Fourth, certain types of claims enjoy a priority status in addition to being sometimes critical to the ongoing nature of the business. For instance, employee wage claims and certain tax claims are both priority claims in whole or in part. The need to pay these claims in an ordinary course of business time frame is simple common sense. Employees are more likely to stay in place and to refrain from actions which could be detrimental to the case and/or the estate if their pay and benefits remain intact and uninterrupted. With respect to taxes, certain prepetition tax claims, such as sales taxes, could be trust fund claims. Obviously the legal right to payment of such claims at any time appears irrefutable. To date, only in these types of situations has the court found the existence of sufficient legal or equitable basis to suggest an exception to the Circuit’s *Oxford Management*<sup>1</sup> rule. Finally, one very important set of factors which play a part in any potential contested matter is the level of sophistication of the parties, the sophistication of their representation, the sufficiency of notice, the extent to which there is unanimous support or strong disagreement, and whether or not there exists potential harm to any sort of “silent” or unrepresented constituencies who rightfully depend upon the Court to follow and apply the law.

In re Equalnet Communications Corp., 258 B.R. 368 (Bankr.S.D.Tex.2000)

The court in Equalnet Communications found that the prepetition contractor could be paid up to the statutory cap of priority wage claims (\$4,300.00), and granted the application to provide customers with billing credits.

The doctrine of necessity describes a common law line of cases which acknowledge the existence of sufficient judicial power in the bankruptcy court to allow a Chapter 11 debtor to pay prepetition claims prior to confirmation of a plan when such

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<sup>1</sup> Matter of Oxford Mgmt. Inc. 4 F.3d 1329 (5<sup>th</sup> Cir.1993) (holding generally the payment of prepetition claims prior to conformation of a plan is prohibited).

payment is vital or “necessary” to the continued operation of the debtor.

In re Equalnet Communications Corp., 258 B.R. 368, 369 n.2  
(Bankr.S.D.Tex.2000).

Thesis of this doctrine has not been limited to “minuet” amounts. See, e.g. In re Mercury Finance Company, 249 B.R. 490, 494 (Bankr.N.D.Ill.2000): noting that early in the proceeding,

The Court ... permitted Mercury, under the doctrine of necessity, to continue to pay trade creditors and various other prepetition and post-petition accounts on a current basis so that all the Subsidiaries could continue operations. These moves were supported by the creditor body and the United States Trustee’s ... office. The only creditors impacted by the reorganization process were, therefore, noteholders, holders of equity interests and options, and those holding securities fraud claims.

(In that case, operations were conducted to the subsidiary level, but cash was swept to the debtor/parent.)

[Chapter 7 attorney’s fees – this issue was side stepped in In re Tom’s, 229 B.R. 646, 659 (Bankr.E.D.Pa.1999)]

An interesting refusal to apply the doctrine is found in In re C.A.F. Bindery, Inc., 199 B.R. 828 (Bankr.S.D.N.Y.1996). There, time of the motions, debtor owed approximately \$16,000.00 in prepetition charges under its lease. The debtor’s lease provided a three month rent concession (which would have come into affect post-petition) if the debtor was not in default under the lease. The debtor sought to compel the granting of the concession notwithstanding the prepetition default. The landlord evidence an intent to give affect to the concession if, at a minimum, prepetition charges were paid (or possibly the lease was assumed). The court first found that the payment failure

constituted a default and that the landlord was not compelled, pursuant to the contract or in equity, to grant the three month concession which would have been otherwise available. The court then turned to the debtor's cross-motion to permit payment of the pre-petition amount under the doctrine of necessity. The court recognized the Doctrine "which permits the bankruptcy court to authorize the payment of prepetition claims prior to confirmation. To invoke the rule, however, the debtor must show that the payment is 'critical to the debtor's reorganization.'" Id. at 835, quoting In re Financial News Network, Inc., 134 B.R. 732, 736 (Bankr.S.D.N.Y.1991), and also citing In re NVR L.P., 147 B.R. 126, 128 (Bankr.E.D.Va.1992) ("the proponent of the payment must show substantial necessity"); In re Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr.S.D.N.Y.Ohio1991) (payment must be "necessary to avert a serious threat to the Chapter 11 process); In re Structurlite Plastics Corp., 86 B.R. 922, 931 (Bankr.S.D.Ohio1988) (payment necessary to "permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately") ... . In this case, however, the court found that because the debtor had not shown an inability to pay the three month rental of \$41,250.00, the debtor "failed to prove the criticality or necessity" of paying the \$1,639.01. Payment of the smaller sum was characterized as the debtor's "preference," with the court concluding, "I can not fill the evidentiary void through the doctrine of judicial notice. The debtor has not produced any financial or other information that demonstrates an inability to pay the larger sum, or that the immediate cure and grant of the concession is critical to or substantially necessary for a successful reorganization." The court ordered the payment of the three month rent within 30 days, granting the landlord relief from the automatic stay to evict if payment was not made.

In *In re Spirit Holding Cove, Inc.* 166 B.R. 367, 369 (Bankr.E.D.Mo.1993), the court rejected utilization of the Doctrine of Necessity to permit payment of sales taxes unless it were demonstrated that such taxes were held in trust.

In *In re Envirodyne Industries, Inc.* 150 B.R. 1008, 1020 n.17 (Bankr.N.D.Ill.1993), the court rejected the Doctrine of Necessity as justifying the employment of counsel who is not disinterested, stating:

The doctrine of necessity is employed by courts to allow debtors to pay necessary prepetition claims when it is essential to keep the business intact and running. This doctrine is not intended, and has never been applied, to by pass a conflict problem and allow the employment of otherwise ineligible counsel.

*In re Envirodyne Industries, Inc.* 150 B.R. 1008, 1020 n.17 (Bankr.N.D.Ill.1993)

[S]ection 105 may not be used as a vehicle to discriminate against priority claims when there is no compelling business need for such discrimination. ... While prepetition claims are normally disposed of in a plan of reorganization and in accordance with statutory priorities, the 'necessity of payment' rule is a narrow exception well-established in bankruptcy common law.

*In re NVR L.P.*, 147 B.R. 126, 127 (Bankr.E.D.VA.1992).

To justify the pre-plan payment of the prepetition obligation the proponent of the payment must show substantial necessity. By definition, the "necessity of payment" rule is a rule of necessity and not one of convenience. For example, some courts have stated the payment must be "critical to the debtor's reorganization," "indispensably necessary" to continuing the debtor's operation, or "necessary to avert a serious threat to the Chapter 11 process." In short, the payment must not only be in the best interest of the debtor but also in the best interest of its other creditors.

*In re NVR L.P.*, 147 B.R. 126, 128 (Bankr.E.D.VA.1992).

There, the court refused to make payment of prepetition incentive compensation to debtor's consultant and former financial officer knew that document, stating that the



debtor had failed to “articulate a compelling business justification, other than a mere appeasement of major creditor, for making the proposed payment...” Id. at 128.

An interesting result of the application of the doctrine arose in *In re UNR Industries, Inc.* 143 B.R. 506 (Bankr.N.D.Ill.1992). **[need to shepherdize this case]** There, the company sought Bankruptcy protection as a result of flood of asbestos litigation. On the day the case was filed, the assigned judge was unavailable, and an emergency judge was assigned to hear first day motions, including an “Application to Authorize Payment of Pre-petition Workmen’s Compensation Claims, Accrued Vacation Pay, and Warranty Claims, and to Permit Issuance of Credit Memoranda, Payment of Customer Deposits and Advertising Allowances, and Issuance of Rebates to Customers.” The application was brought under the Doctrine of Necessity, with the justification for such motion including that payment was necessary in order to maintain “employee morale and customer relations” and “the good will and viability of the debtors-in-possession.” The judge was also told that the ability of the debtors to remain self insured for workmen’s compensation depended upon payment of prepetition workmen’s compensation claims. The application was granted. The debtor confirmed a plan approximately seven years later, treating asbestos claimants in Class 5 and workmen’s compensation claims as fully payable in Class 2. The asbestos claimants holding workmen compensation claimants successfully argued that they were Class 2 creditors, and further that the first day order required payment of their claims in full. Coming to this conclusion, the court liberally interpreted the Doctrine of Necessity, stating:

UNR’s interpretation of the Necessity Doctrine is overly restrictive. The purpose of the Necessity Doctrine is to facilitate a debtor’s effective reorganization and continued operations. ... UNR is correct in asserting that the Necessity Doctrine may be

used to permit a debtor to pay the pre-petition claims of suppliers or employees whose continued cooperation is essential to the debtor's successful reorganization. The Necessity Doctrine may also be used, however, to justify post-petition payment of a wide variety of other types of pre-petition claims, as long as payment of those claims will help to "stabilize [the] debtor's business relationships without significantly hurting any party.

Id. at 519-20, *quoting* Russell A. Eisenberg and Frances F. Gecker, The Doctrine of Necessity and Its Parameters, 73 MARQ.L.REV. 1, 2 (1989).  
**[need to obtain copy]**

In re Financial New Network, Inc., 134 B.R. 732, 735-36 (Bankr.S.D.N.Y.1991), the court refused to except the Doctrine as permitting payment of prepetition counsel fees, stating that counsel's:

[R]eliance on the Doctrine of Necessity is clearly misplaced. To invoke the doctrine and allow the payment would be to read the doctrine as one of convenience rather than necessity. ... Even if we were willing to place ourselves in the camp of those who would extend the "doctrine of necessity" beyond the railroad cases, application of the doctrine is unwarranted under the facts presented here.

Id. at 736.

The Court held that the Doctrine would not be applied to compel airline debtor to adopt refund procedure for prepetition ticket holders in In re Ionosphere Clubs, Inc., 101 B.R. 844, 855-56 (Bankr.S.D.N.Y.1989).

In In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr.S.D.N.Y.1989), the court considered a motion filed by a labor union to enter an order authorizing and directing the debtor to pay prepetition priority wage, salary, and medical benefit claims. The court approved the motion insofar as it applied to active employees not to striking employees, since such payment would have "no demonstrable benefit to the value of the Debtor's estate." Id. at 178. The court rejected the union's argument that section 105 does not

empower the bankruptcy court to afford to spare out treatment to similarly situated creditors. The Court held that: “the policy of equality among creditors...may be of significance in liquidation cases under Chapter 7, however, the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor.” Id. at 176.

The court traced the history of the Doctrine to *Miltenberger v. Logansport, C. & S.W.R. Co.*, 106 U.S. 286 (1882). This case and other railway cases, recognize the necessity of payment doctrine or the Doctrine of Necessity as permitting immediate payment of claims of creditors where those creditors would not supply services or material essential to the conduct of the business until there pre-reorganization claims have been paid. Court attributed the reach of the Doctrine to the non-railroad debtor and Judge Leonard Hand in *Dudley v. Mealey*, 147 F.2d 268 (2d Cir.1945), cert denied, 325 U.S. 873 (1945), stating “that a court was not ‘helpless’ to apply the rule to non-railroad debtors for the alternative was a cessation of operations.” The court found that the Doctrine arises from both section 363, permitting the use of assets outside the ordinary course of business, and section 105(a), which permits the court to issue any order, process, or judgment necessary or appropriate to carry out the provision of Title 11.

The Doctrine is often cited in applications to prove payment of “critical vendors.” “Since enactment of the Code, various courts have permitted debtors-in-possession to pay pre-petition debts on the grounds that payment of such claims was necessary to effectuate a successful reorganization, or at least give the debtor the opportunity to propose any type of plan at all.” *In re Payless Cashways, Inc.*, 268 B.R. 543, 546 (Bankr.W.D.Mo.2001).

As the United States Trustee points out, the Code establishes the priority in which claims are to be paid, either pursuant to a Chapter 11 plan or in the liquidation of Chapter 7 estate. Prior to enactment of the Code, however, courts recognize that in certain circumstances it was in the best interest of all concerned to pay certain prepetition creditors out of turn, as an endorsement to them to continue for, or doing business with, the debtor. Prior to enactment of the Code, this practice was justified under what was known as the "Doctrine of Necessity", the idea being the payment of those claims was necessary to keep the debtor in business, and that keeping the debtor in business and its employees at wage paying jobs, was in the best interest of all concerned. Since in enactment of the Code, various courts have permitted debtors-in-possession to pay prepetition debts on the grounds that payment of such claims was necessary to effectuate a successful reorganization, or at least to give the debtor the opportunity to propose any type of plan at all. *Id.* Here, the debtor requested that the court grant administrative expense priority in order to permit payment of certain critical lumber vendors' prepetition claims, to the same extent that those vendors agreed to extend post-petition unsecured credit on specified terms. The court stated:

In applying these principles to a request to prefer certain creditors as part of a borrowing agreement, the Court must be guided by practicality and common sense. If the court is satisfied that the debtor will not be able to obtain inventory or labor of the same quality on a timely basis, and that that is critical to survival of the business, the Court must decide whether the granting of preferential treatment to some creditors is better result than closing the business, or allowing it to die slowly for lack of necessary supplies.

Id. at 547.

The court noted as critical the fact that the unsecured creditors committee supported the application (which was opposed only by the office of the United States Trustee). The court granted the motion with some modification, for example limiting the administrative expense priority to 90% of the amount credited extended post-petition. The court found statutory authority to do so and 11 U.S.C. § 364(b) as permitting the court to allow the debtor to obtain credit of outside the ordinary course of business.

Conversely, *In re Coserv, L.L.C.*, 273 B.R. 487, 493 (Bankr.N.D.Tex.2002), was recognition that:

The Court finds no support in Section 549 or Section 363(b)(1) for payment of prepetition claims. Only Section 105(a) offers the equitable muscle that would allow a bankruptcy court to violate one of the principal tenants of Chapter 11: that prepetition general unsecured claims should be satisfied on an equal basis pursuant to a plan.

The Court then recognized the Doctrine but limited it to permit bankruptcy court to “order payment of unsecured prepetition claims only under the most extraordinary circumstances.” *Id.* at 494. While the court recognized certain examples of cases in which the Doctrine of Necessity might be available, citing foreign creditor beyond the bankruptcy’s reach it enforces a prepetition claim against foreign assets or refuses absent payment, to supply a unique piece of equipment or manufacturing component; prepetition consumer warranty or refund claims which, if not honored, could so harm the debtor’s good will as to destroy its going concern value; and rental deposits or other claims that arise prepetition but come due post-petition and may require payment to avoid sanctions under state law as well as the laws of good will. The court then developed a three part test which the debtor must meet in order to prove the necessity justifying payment of a general unsecured prepetition claim. First, it must be critical that the debtor deal with the

claimant. Second, debtor must show that unless it deals with the claimant it risk the ability of harm, or alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there must be no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. With regard to the third task, the court suggested numerous practical alternatives to payment of a prepetition claim in order to provide vendors assurance of payment for post-petition deliveries, including deposits, COD terms, payment on shipment, and "countless other devices ... that will not offend the general principle that prepetition claims should not be paid." Based upon such considerations, the court denied the motion except as to the payment of an employee claim (which the court noted as being payable either as an assumption of a contract or as wage priority), and an essential traffic engineer.

The most stunning rejections of the uses of Doctrine of Necessity for payment of critical trade vendors that came with the District Court decision in *Capital Factors, Inc. v Kmart Corporation*, 291 B.R. 818 (N.D.Ill.2003). The District Court reversed first day order for payment of critical vendors. The court considered the issues arising solely under Section 105(a) under the Doctrine of Necessity. The court noted that section 105 permits the use of equitable powers to enforce the code, not to add to it. *Id.* at 822. The court further noted that 11 U.S.C. §§ 503 & 507 set forth a priority scheme which do not include a carve out for prepetition general unsecured claims based on the critical or integral status of the creditor. *Id.* The Court recognized a split of authority as to whether Section 105 authorizes bankruptcy courts to permit payment of prepetition unsecured

claims outside the plan of reorganization, finding that such an authorization was not appropriate. The court ruled:

We acknowledge that the application of the “doctrine of necessity” through § 105 in this situation is well-intended and may even have some beneficial results, in that pre-plan payment of certain prepetition claims allows the debtor to minimize disruptions in doing business, and thus may further reorganization. Nevertheless, it is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.

Id. at 823.