



Bankruptcy Court Prefers Adjusted Balance Sheet Test to Confirm *Hard Rock* Plan

In re Premier Entertainment Biloxi LLC, 2010 WL 3504105 (Bkrcty. S.D. Miss)(Sept. 3, 2010)

Just two weeks after its grand opening, the Hard Rock Hotel and Casino in Biloxi, Miss., was nearly destroyed by Hurricane Katrina. The owners eventually recovered \$181 million from their insurers, but disputed their rights to the funds with its first lien note holders. The casino ultimately filed for Chapter 11 bankruptcy because they could not access the funds to finish construction.

Between a rock and a hard place. Almost immediately after filing, the debtors proposed to pay the notes at par value plus interest, thereby extinguishing the note holders' liens and releasing the insurance proceeds. The bankruptcy court confirmed the plan and released the funds, despite objections from the note holders who claimed they were still owed \$10.75 million in prepayment penalties pursuant to the original security agreement and the Bankruptcy Code. In particular, Sec. 502(b) permits unsecured creditors to recoup damages from a solvent debtor, they argued, and the debtors were solvent at all times, because, simply put, "their debts never exceeded their assets." The debtors had access to more than \$40 million in financing from a secondary source, which had already invested over \$150 million in rebuilding the resort.

By contrast, the debtors insisted they were "equitably" insolvent as of the bankruptcy petition, because without access to the insurance proceeds, they had only \$200,000 in cash and over \$230 million in outstanding liabilities. More importantly, they were in danger of losing their Hard Rock license and any opportunity to successfully rebuild. After reviewing a "wealth of evidence" from both parties, the court ultimately said the issue turned on which solvency test applied: the adjusted balance sheet test, as proposed by the note holders, or the debtors' "equitable insolvency" test, derived largely from statutory case law concerning fraudulent transfers.

To support the former, the note holders' solvency expert testified the debtors had nearly \$253 million in assets and only \$230 million in liabilities per their bankruptcy schedules. He made two adjustments. First, he increased the Hard Rock license from its \$472,000 book value on the schedules to over \$11.8 million, the value on the debtors' application for secondary financing and SEC

filing. Second, he included \$17.5 million for construction in progress, which the debtors also reported to their lenders but omitted from their cost-basis bankruptcy balance sheets. After these adjustments, the debtors' assets exceeded liabilities by roughly \$50 million at the time of filing. Even on a cost-basis approach, assets exceeded liabilities by over \$28 million.

The debtors did not present their own expert, but maintained they had limited usable cash at the time of filing and owed hundreds of millions, including \$160 million to the note holders. Several trade vendors had filed lawsuits and liens, and three or more could have filed an involuntary bankruptcy petition, they said, thereby meeting the equitable insolvency test.

But that test applied to limited factual circumstances, the court ruled. In this case, the adjusted balance sheet was "the traditional bankruptcy test of insolvency." The adjustments by the note holders' expert were appropriate—in particular, his use of the market value of the Hard Rock license, as corroborated by its assigned value in the debtors public filings and loan documentation. Accordingly, the court found the debtors were solvent at all relevant times and awarded the note holders their unsecured claims for \$10.5 million liquidated damages.