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A Postmortem:
How Station Casinos Insiders Drove the Company into Bankruptcy

The Chapter 11 bankruptcy of Station Casinos, one of the top gaming companies in the U.S. and one of the largest employers in Southern Nevada, has had a profound impact on the Las Vegas community. While many people have portrayed the company as a victim of the current recession, a review of the facts suggests a more disturbing story of insider self-enrichment at the expense of the corporation and other company stakeholders such as employees, customers, lenders, and vendors.

Company insiders at Station Casinos – led by members of the Fertitta family and including other long-time executives and directors – amassed over $1 billion of wealth from the company through stock-based compensation and direct payments from 2001 through the 2007 buyout. This transfer of wealth was directly and indirectly paid for by making the company take on billions of interest-bearing debt. It was this debt used for insider enrichment that made it impossible for the company to weather the severe economic downturn.

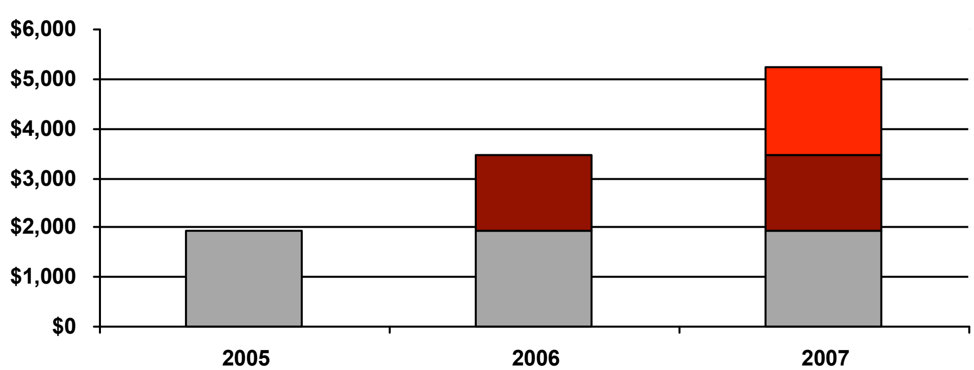
This report details the ways by which company insiders extracted such wealth from Station Casinos, how it led to the company's bankruptcy, and a proposed solution that would benefit all stakeholders of the company.

The Cause of Station Casinos' Bankruptcy

As Station Casinos announced its Chapter 11 bankruptcy filing on July 28, company officials were quick to blame the severe economic downturn for the company's downfall. In the company's official statement announcing its Chapter 11 filing, Frank Fertitta III, Chairman, CEO and a principal owner of Station Casinos explains: "Our 18 casinos and resorts continue to generate positive cash flow, but the global recession has severely impacted our company, just as it has every other company in the gaming industry."[1]

However, rather than lower revenue as a result of the recession, it was the company's debt load that forced the bankruptcy filing.

2006-2007 Debt Increases at Station Casinos ($millions)



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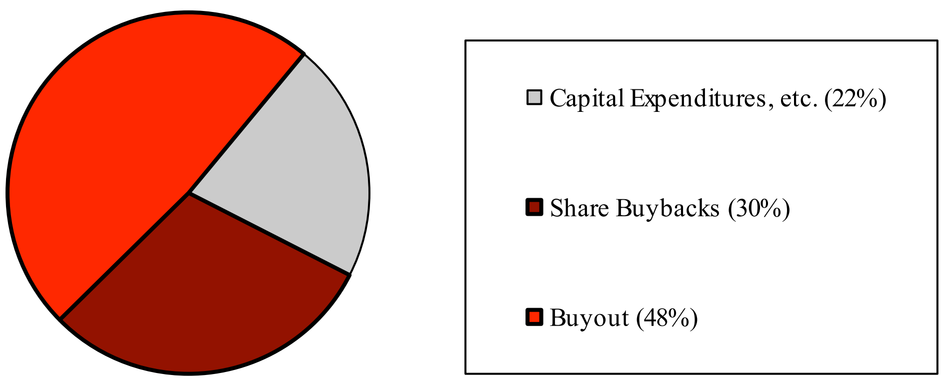
The "substantial liquidity challenges"[2] that threw the company into bankruptcy court were primarily caused by the almost tripling of the company's long-term debt from $1.9 billion in 2005 to $5.2 billion by the end of 2007. More debt means higher interest expenses. Through the end of September, 2009, the company had trailing-twelve-month EBITDA (earnings before interest, taxes, depreciation, and amortization, a common measure of a company's cash flow) of $336 million, which was 30% lower than its 2005 EBITDA. But, even that amount would have been sufficient to cover the company's 2005 interest expense of just $87.5 million. In other words, Station Casinos would not have sunk into a liquidity crisis if it had not taken on so much debt since 2005.

The question thus begs itself: Why did the Station Casinos take on so much debt since 2005? What did it do with these billions of dollars of borrowed money?

Uses of Debt by Station Casinos, 2006 - 2007



A close analysis of the company's financial statements suggests that, of the slightly more than $3.3 billion of debt the company took on in 2006 and 2007, less than a quarter of the borrowed money went to growth capital expenditures or other productive uses. The rest of the borrowed money was spent on share buybacks ($990 million) and a leveraged buyout ($1.6 billion) that did not serve immediate and compelling strategic purposes. Instead, they were directly and indirectly related to stock compensation and enrichment of insiders at Station Casinos.

The 2006-2007 Share Repurchases: $990 Million Price Tag for Excessive Stock Compensation Practices

In 2006 and through the first three quarters of 2007 (basically before the November, 2007 buyout), Station Casinos added $1.7 billion of new debt onto its balance sheet. Some of the borrowed funds went to capital expenditures one would expect for a fast growing company like Station Casinos. For example, these included new development (Red Rock Resort), property expansion (Santa Fe Station, Sunset Station), purchases of land for future projects, and advances for Native American gaming projects. But approximately $990 million of the borrowed funds in this period went to repurchase company shares on the open market. In our view, this non-productive use of borrowed money can be best understood as the "true cash cost" of the company's lavish stock compensation practice, which disproportionally benefited a small group of insiders at the top of the firm.

Station Casinos' stock compensation practice had drawn strong opposition from the company's outside shareholders and corporate governance experts. For example, in 2003, when the company asked shareholder approval to continue its existing stock compensation program, more than half of the shares not owned by company insiders voted no or abstained, after a public campaign against the proposal led by the Culinary Workers Union.[3] (The proposal passed by a slim majority anyway, as company insiders presumably all voted yes.) Institutional Shareholder Services, the world's largest proxy voting firm, also consistently opposed proposals by Station Casinos to expand their stock compensation programs. In 2005, Glass Lewis, another independent adviser to large institutional investors, called the company's stock compensation plan "the most expensive and liberal we have reviewed" and an "excessive transfer of wealth" to insiders.[4]

The reason that outside shareholders opposed the stock compensation plans at Station Casinos was simple: Giving more and more company stock to insiders in the form of stock options or restricted stock awards diluted the value of the shares owned by outside shareholders because such grants increased the number of shares outstanding at the company. At Station Casinos, the number of shares outstanding shot up from 57.4 million in 2001 to 68.5 million in 2005, an increase of 11.2 million shares, or a 20% increase. This dilution was due almost entirely to company stock issued under its stock compensation programs, which led to the exercise of 11.9 million stock options from 2001 to 2005 and the grant of another 2.1 million of restricted stock awards by the end of 2005. Significantly, insiders accounted for 9.2 million or two-thirds of these 14.0 million shares.

While issuing more shares of stock does not involve immediate cash outlays, there is a cost to the company for using stock compensation. The Center for Financial Research and Analysis (CFRA), a leading accounting research firm, argues that the money spent on stock repurchases are a good estimate for the true cost of stock compensation plans like Station Casinos'. According to CFRA, "a Company may have a stock repurchase program in place to offset the dilution from employee stock option exercises. While the amount of cash used solely to offset dilution is difficult to estimate we believe this is an excellent proxy for the true cash cost of stock option compensation expense."[5]

In the case of Station Casinos, the "true cash cost" of its generous stock compensation was a steep one. Starting in 2006 through the third quarter of 2007, the company spent $990 million of borrowed money to repurchase 14.0 million shares of its common stock, essentially the same number as the $14 million of shares it had issued through exercised stock options and restricted stock awards before 2006. Through these repurchases, the company was able to reduce its number of share outstanding to 56.0 million by the end of third quarter of 2007, slightly lower than the 2001 figure of 57.4 million. **In effect, the company borrowed $990 million to pay for the cost of its generous use of stock-based compensation, two-thirds of which had gone to a small group of insiders.**

The 2007 Leveraged Buyout: $1.6 Billion Transaction to Enrich Insiders

In 2007, Station Casinos announced that a group consisting of Colony Capital, members of the Fertitta family, and other insiders would acquire the company for $90 a share, using primarily debt to finance the transaction. The transaction added $1.6 billion of net debt to the company's balance sheet, and company insiders, who had large shareholdings, benefitted disproportionally from the transaction, cashing out over $660 million.

According to disclosures filed with the Securities and Exchange Commission, one of the rationales for the transaction was that "[a]s a privately held entity, Station will have greater operating flexibility, allowing management to concentrate on long-term growth, reduce its focus on the quarter-to-quarter performance often emphasized by the public markets and pursue alternatives that Station would not have as a public company."[6]

But as Dennis Neilander, Chairman of the Nevada State Gaming Control Board, remarked during the licensing hearing on the buyout, it was not absolutely clear the company needed to be taken private to pursue growth opportunities or access new financing: "The only thing troubling to me is that the company will be…significantly more leveraged….While the company could probably do the things we have talked about by remaining public, it's chosen to take a different avenue and access a different type of capital market, I'm not going to substitute my judgment for that of the company."[7] In spite of such reservations, the state gaming authorities ultimately approved the buyout.

If Station Casinos did not really have to go private to pursue its strategic goals, what other motivation was there for the transaction? As revealed in the company's merger proxy, a "primary purpose" of the proposed transaction for the insiders, specifically Frank Fertitta III and Lorenzo Fertitta, was to "immediately realize in cash the value of a portion of their respective holdings in Station."[8] And the buyout certainly realized tremendous value for company insiders. Of the $4.2 billion cash consideration paid to shareholder for the buyout, the Fertittas, the Sartinis (Delise Sartini is the sister of the Fertitta brothers), other long-time executive officers and directors received a very large proportion of the total because of their significant ownership stakes in the company.

Payments to Insiders Due to the Buyout

Name	Position at Time of Buyout	Total Cash Received
Blake & Delise Sartini	Large Shareholders	$200,919,330
Frank J. Fertitta III	Large Shareholder, Chairman of the Board, CEO	$148,654,355
Lorenzo J. Fertitta	Large Shareholder, Vice Chairman of the Board, President	$145,069,850
Glenn C. Christenson	Former Chief Financial Officer	$51,889,130
Scott M. Nielsen	Chief Development Officer	$41,130,055
William W. Warner	Chief Operating Officer	$39,825,510
Richard J. Haskins	General Counsel	$16,563,680
Thomas M. Friel	Chief Accounting Officer	$5,860,265
James E. Nave, D.V.M.	Director	$3,641,700
Lowell H. Lebermann, Jr.	Director	$2,801,700
Lee S. Isgur	Director	$2,205,000
Robert E. Lewis	Director	$1,575,000
Total		**$660,108,059**

These top insiders of the company were paid more than $660 million for the buyout, with members of the Fertitta family receiving $495 million.[9] Thanks to cash equity contributions from Colony Capital and rollover equity contributions from some of the insiders listed here, the transaction was not entirely funded by debt. **Still, for the buyout, Station Casinos took on $1.6 billion of net new debt, with 40% of the amount going directly to company insiders.**[10]

The Buyback and Buyout Debts Caused the Bankruptcy

If the company had foregone these two non-productive transactions – $990 million for the buybacks to pay for its stock-based compensation and the $1.6 billion for the strategically dubious buyout – it could have borrowed $2.6 billion less since 2005. To have $2.6 billion less debt would have meant approximately $176 million less in annual interest expense, assuming the same weighted-average cost of debt the company had in the second quarter of 2009 at 6.8%.[11] That would have translated into annualized interest expense of only about $250 million, which the company would have been able to pay with its current level of annual EBITDA of approximately $336 million.

But the company did in fact borrow this additional $2.6 billion and did eventually go bankrupt because of it, even as a small group of insiders got wealthy in the process and other stakeholders in the company are left to suffer the consequences of the financial distress the company fell under.

Insiders Win, Las Vegas Loses

Leading up to and through the 2007 buyout, insiders at Station Casinos – members of the Fertitta family and other top executives and directors – received more than $1 billion from the company:

- $660 million in cash payments from the company due to the 2007 buyout;
- $250 million in cash from the exercise of stock options before the buyout;
- $85 million in restricted stock grants; and
- $70 million in salaries, bonuses, incentives, benefits and perks.

Other stakeholders in Station Casinos, however, fared less well. In fact, the financial pressure on the company following its 2006-2007 debt binge led to draconian cost-saving measures by management. In the past two years, the company has:

- stopped its matching 401(k) contributions, even if its contributions had been miserly compared to its executive compensation package – the employer contribution was only $2.4 million in 2004 while total compensation for the company's top five executives was more than $144 million in the same year;[12]
- more than doubled PPO health care premiums for rank-and-file workers;
- slashed shifts and cut hours for workers; and
- terminated hundreds of long-time employees by replacing coffee shops with subcontracted restaurants, a move which some industry observers caution could cause the company to "lose control of the customer experience" and lead to sacrifices in "service, diversity, operating hours, quality control" and so on.[13]

Other stakeholders have also been negatively impacted. For example:

- According to bankruptcy filings, Station Casinos owes hundreds of thousands of dollars to Southern Nevada-based businesses.[14]
- The company's bondholders holding billions of unsecured notes have seen the value of their holdings plummet. For example, the company's 6% senior notes due 2012 and 6.5% senior subordinated notes due 2014 were both trading slightly above par at the end of 2005. Now the same senior notes are valued at just 20 cents on the dollar and the same senior subordinated notes fetch only two cents on the dollar on the market.[15]

Save Station Casinos, Save Las Vegas

Culinary Workers Union Local 226, UNITE HERE, represents over 55,000 gaming workers in Las Vegas. Our members – the Las Vegas "locals" that Station Casinos caters to – often have friends and family that work for one of the 18 Station Casinos properties in the valley. Like many others in our community, we are increasingly concerned about Station Casinos' future, especially as restructuring negotiations appear to be proceeding at a slow pace.

Station Casinos has long trumpeted its "commitment to the communities in which we operate,"[16] spending considerable resources advertising its charitable activities or its FORTUNE "best company to work" awards (a title it lost in 2009). Because of its unique place in Southern Nevada as one of the largest employers and the pre-eminent operator of locals casinos, its management's actions impact not only the company's insiders but also other stakeholders in the wider local community. It is clear that the insiders who have been the company's owner-managers have failed to act responsibly in this regard. They enriched themselves by piling on debt on the company to the point of bankrupting it, while the other stakeholders now suffer the consequences of the company's descent into financial ruin. From this perspective, we believe that any fair and equitable plan of reorganization that ultimately emerges should include as a key element the substantial return of the wealth by company insiders to the company.

Station Casinos insiders certainly have the financial resources to do the right thing here. For instance, outside of Station Casinos, the Fertittas and the Sartinis own other fast-growing companies. The Fertittas are principal owners of Zuffa LLC, the parent company of the fast-expanding mixed martial arts promotion, the Ultimate Fighting Championships (UFC), which is now commonly estimated to be worth approximately $1 billion.[17] Blake Sartini is the principal owner of Golden Gaming, Inc., which had put forward a proposal for a $660 million gaming resort in Kansas last year, with partial funding by Sartini himself.[18] These individuals, who have taken so much from Station Casinos and the community it is based in, can and should put money back into the company to help resurrect it out of bankruptcy. They owe it to Station Casinos and they owe it to Las Vegas.

Notes

1. "Station Casinos Voluntarily Files Chapter 11 Petition to Restructure Its Debt; Filing Will Not Affect Casino Operations, Guests, Or Employees," press release by *Station Casinos, Inc.*, 7/28/09; http://www.stationcasinos.com/corp/newsroom/releases/2009/073009.php.

2. "Omnibus declaration of Thomas M. Friel in support of the Debtors' Chapter 11 petition and first day motions," docket #19 in case 09-52470-gwz, entered 7/28/09.

3. See the company's proxy for the number of insider votes and its 10Q filed 8/14/03 for the results of the 2003 annual meeting. Excluding 23.8 million insider votes, 14.8 million shares voted yes, 13.9 million voted No, and 3.2 million abstained with regard to the proposal.
4. Proxy advisory report on Station Casinos' 2003 annual meeting by Glass Lewis, 5/12/03.
5. "Issuing Debt to Fund Share Repurchases," *Center For Financial Research and Analysis*, 1/28/05.
6. Station Casinos, DEFM14A, 7/9/07.
7. Transcript of 10/4/07 Gaming Control Board hearing.
8. Station Casinos, DEFM14A, 7/9/07.
9. See Station Casinos, 10-K/A, filed 4/27/07 and Report by the Special Litigation Committee, 9/11/09.
10. See Report by the Special Litigation Committee, 9/11/09.
11. Station Casinos, 10Q, 8/14/09, p. 39.
12. See 5500 filings by Station Casinos, Inc. and Green Valley Ranch Gaming LLC on www.FreeERISA.com.
13. "Tradition at risk: many locals casinos choosing familiar chain brands over traditional coffee shops," *Las Vegas Review Journal*, 10/14/09; http://www.lvrj.com/taste/many-locals-casinos-choosing-familiar-chain-brands-over-traditional-coffee-shops-64197767.html.
14. Schedule F – Creditors holding unsecured non-priority claims, docket #487 in case 09-52477-gwz, entered 10/20/09.
15. According to historical and current market data available from the Financial Industry Regulatory Authority (FINRA) website, http://cxa.marketwatch.com/finra/BondCenter/Default.aspx.
16. See, for example, the "Community" section on the company's website, www.stationcasinos.com.
17. "Ultimate challenge for Stations exec," *Las Vegas Review-Journal*, 6/19/09; http://www.lvrj.com/news/20557739.html.
18. "Golden Heartland Casino-Resort-Spa: Lottery facility gaming review board presentation," *Golden Gaming, Inc.*, 8/14/08.