New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 245—NO. 66
THURSDAY, APRIL 7, 2011

**SECURED TRANSACTIONS**

# Play Ball: Lending To Pro Sports Franchises


By **Alan M. Christenfeld**
And **Barbara M. Goodstein**

The crack of the bat ushered in a new baseball season last week, but the financial problems that several sports franchises (especially the New York Mets) are experiencing have been focusing attention off-the-field to the teams' capitalization since well before Opening Day. Today, we examine some issues that secured lenders face when financing the acquisition or ongoing operations of, or restructuring loans to, franchises in the four major North American professional sports leagues—Major League Baseball (MLB), the National Football League (NFL), the National Basketball Association (NBA) and the National Hockey League (NHL).[1]

## Background

Modern sports franchises often form just one part of multi-tiered ownership structures that are relatively complex for businesses of comparable size, and they and their associated ventures provide an array of potential collateral, including the franchises themselves, venues, regional sports networks, media rights, naming rights and many others. North American professional sports franchises typically are owned through operating companies ("franchise owners") formed by ultimate individual or corporate owners ("ultimate owners"). Whereas a team financing 30 or 40 years ago may have been underwritten by a commercial bank's private banking division on the strength of a wealthy individual owner's personal guarantee, the leverage necessary to purchase and operate a professional franchise at today's high values often surpasses the ability or appetite of any individual to guarantee such debt. Lender due diligence on the asset and related ownership structure is therefore a critical initial step when structuring a team financing.

The debt component of the purchase price for a franchise typically includes a large syndicated term loan in addition to a revolving credit facility for ongoing working capital needs. A revolving credit facility alone is often used to finance purely ongoing operations. Although we focus here on financing in the form of secured commercial loans, franchise owners also have occasionally raised debt capital by other means (e.g., privately placing notes with insurance companies) that are beyond the scope of this column.

As standalone entities separate from related stadium/arena owners and regional sports networks, many franchise owners do not generate material positive cash flow, and loans secured by franchises thus must be underwritten on the value of the franchise rather than on cash flow. Accordingly, term loans typically are structured with bullet amortization at maturity and rely on minimal financial covenants. Credit documentation also may include a so-called "operating support agreement," pursuant to which one or more ultimate owners agree to inject additional capital to help the franchise owner meet its obligations if, as and when necessary. Those obligations often include debt service. Unlike loan guaranties, which benefit the lenders, an operating support agreement runs in favor of the franchise owner. Nevertheless, lenders customarily obtain the right to enforce the ultimate owners' operating support agreement obligations directly and also benefit indirectly when those owners agree to support the lenders' paramount collateral. Like greenfield project financings, professional franchise credit documents also may require prefunded interest and other reserve accounts, including accounts funded to service debt during strikes and lockouts.

## Collateral

An important aspect of lender diligence is identifying an appropriate collateral package. Lenders should expect to receive liens on all assets of the franchise owner necessary to operate the team, the most important of which is the franchise itself. Stadium/arena operating rights and regional sports networks typically are held elsewhere in the corporate structure by other entities that are financed separately, and thus those assets usually are not available to secure franchise loans. Franchise owners, however, do own rights for the team to use a stadium/arena to play its home games and to practice as well as media rights to license broadcasts of its games to regional sports networks and other broadcast partners. Taking a lien over stadium/arena use rights often requires consent from a municipal development authority that owns the building or land on which the building is located. Although media contract rights are similar to other contract rights available as collateral, lenders may wish to require direct payment of television broadcast revenue to service debt; in that case, acknowledgment by the broadcast partners is advisable. Other critical assets forming part of the collateral

ALAN M. CHRISTENFELD *is senior counsel at Clifford Chance US.* BARBARA M. GOODSTEIN *is a partner at Dewey & LeBoeuf.* JASON YOUNG, *a partner at Clifford Chance US, co-authored this article, and* OWEN ZINGRAFF, *an associate at Clifford Chance US, assisted in its preparation.*

package are intellectual property, receivables, deposit accounts, equity in subsidiaries, player contracts[2] and other contract rights. Hard assets such as equipment, bats, balls, pucks and uniforms are likely the least valuable collateral.

The next critical step is creating and perfecting liens. Article 9 of the Uniform Commercial Code covers most of the assets, and therefore its perfection requirements, such as filing financing statements, taking possession of certificated securities and other instruments and entering into account control agreements, will apply. Other assets, such as real property interests and insurance policies, fall outside Article 9's scope and thus must be addressed separately.

Obtaining a lien on stadium/arena use rights requires an understanding of applicable state law. The right to use a venue constitutes either a lease, which is a real property interest, or a license, which is a personal property contract right—and the name of the document does not necessarily govern how the interest will be treated under applicable state law. The difference is important because the asset's characterization will dictate the appropriate method of creating and perfecting liens—a lease requires a leasehold mortgage or deed of trust and filing in the relevant local mortgage recording office whereas a license requires a security agreement and the filing of a UCC financing statement in the franchise owner's jurisdiction of organization. Also, landlord-tenant law generally provides greater protections for lessees than general contract law provides for licensees. If the relevant state's characterization of the asset is at all in doubt, prudence dictates that dual real estate and UCC filings be made.

Casualty and liability insurance are important assets for any business. Secured lenders retain perfected liens on insurance proceeds to the extent they had perfected liens on the underlying asset.[3] As with other secured loans, lenders to franchise owners expect to be named as additional insured on liability policies and loss payee on casualty policies.[4] Insurance as original collateral is excepted from Article 9, however, and thus liens on such insurance policies must be obtained under common law. Common law liens generally require collateral assignments and acknowledgment by the insurer. Such assignments are also a direct way of trapping cash payouts under policies that do not insure collateral. For instance, secured lenders may want to take as additional collateral payments under life or disability insurance policies the franchise owner takes out on star players who are critical to the team's value, as is common with key-employee policies in the corporate world.

**Special Issues**

The four major leagues operate as not-for-profit corporations or associations of their member franchises, with each franchise granted rights to operate a team in a specified geographic territory. Although each league has its own rules and regulations developed under the framework of a constitution, by-laws and other written and less formal policies, the maintenance of the quality and integrity of the league, as a whole, is a primary objective of each league. To achieve that objective, the leagues use various means, one of which is to require league consent for major business transactions such as financings with recourse to franchise assets. With the leagues creating and enforcing the rules of the game, lenders considering financing professional franchises must understand how league consents work.

> Experienced sports lenders take comfort that the benefits of relatively low leverage ratios and other league controls, including supporting ongoing operations and success of member franchises and potentially brokering sales of troubled franchises, outweigh the restrictions the leagues require.

Each major league attempts to police its respective franchises' financing arrangements up front by conducting a review of every proposed financing. The leagues scrutinize acquisitions and related financings of controlling franchise interests more strictly than those of minority interests, but each such review is detailed and comprehensive. Moreover, lenders generally are required to execute a letter confirming their agreement to league rules and restrictions on financing terms.

Although lender consents vary in form, length and complexity among the leagues, they focus primarily on two aspects of any franchise financing—the amount of debt and the degree of recourse to franchise assets. Each league imposes debt limits on its franchises, calculated either as a set dollar amount, a percentage of franchise value or a multiple of earnings or cash flow. Depending on the league, the debt limit can apply to any entity with a direct or indirect interest in franchise assets and therefore can restrict loans to franchise owners and holding companies alike.

Debt at various levels in the ownership structure featured prominently in the recent financial turmoil of the NBA's New Orleans Hornets and MLB's Texas Rangers and Chicago Cubs. After failing to reach agreement with potential buyers, particularly the team's minority owner, majority owner George Shinn sold the Hornets to the NBA after it became apparent that he could no longer support the franchise financially. Both MLB teams, on the other hand, became embroiled in bankruptcy proceedings not because of their own insolvency but, rather, due to the financial problems of their ultimate owners or holding companies. The Tribune Company, which among other things owned the Chicago Tribune and 95 percent of the Cubs, fell victim to the newspaper downturn after incurring significant debt in real estate mogul Sam Zell's 2007 leveraged buyout. Debt of the Rangers' holding company, which continues to own the NHL's Dallas Stars, led to the Rangers' bankruptcy.

The owners of MLB's Mets and Los Angeles Dodgers currently appear to face similar problems. Particularly for ultimate owners who are natural persons, the appreciation of franchise values has resulted in franchises comprising a more substantial share of their net worth. This modern-day reality, together with more financially distressed teams, has led one senior baseball official to state, "[a]n issue that will be on the table in 2011 will be upstream holding company debt."[5]

Debt limits serve to ensure conservative capital structures, but league concerns over collateral pledges of franchises are more fundamental. Although sports lenders obtain liens under personal and real property laws familiar to most secured transaction practitioners, league consents limit the enforcement of the lenders' legal remedies in uncommon ways. In essence, the leagues want to prevent lenders from operating a franchise after default or conducting a foreclosure sale of the franchise to the highest bidder, as might occur following a default in a typical secured financing.

The leagues prefer to control the sale process, rather than suffer a quick lender-run foreclosure sale that they view as potentially disruptive to the team and the league. Thus, following any default and notice of enforcement by lenders, league consents typically impose a standstill period (often 180 days) during which the league retains the exclusive right to seek purchasers for the franchise. Lenders customarily waive objections to any league-run sale that (a) generates proceeds sufficient to repay the loans fully or (b) results from an open-market, arms-length process, even if a deficiency remains after the sale proceeds are applied to repay the loans. Even if the league does not broker a sale during the standstill period, it still asserts approval rights and requires that the purchaser acquire the team together with the bundle of rights associated with it (such as media and venue rights) that are necessary to operate the team as a going concern. Lenders are thus presumptively barred from exercising their UCC §9-610(b) right to sell the collateral in separate parcels to different bidders at different times.

League consents provide other protections for the league, including lenders' acknowledgement that the league has authority to take over operations of troubled franchises and that monies owed to lenders are subordinate to team obligations to the league. The primacy of league obligations is particularly important because, if traditional financing sources for a troubled franchise evaporate, a league may step in as a lender of last resort. MLB, for example, reportedly loaned approximately $75 million in emergency funds to the Mets last year, and that debt has priority over the approximately $430 million the Mets owe their secured lenders.[6]

Leagues have also limited the liquidity of franchise loans by imposing restrictions on and/or consent rights for loan assignments and participations. Leagues rely on such restrictions to control trading in distressed franchise debt and thereby prevent "vulture" investors from buying franchise loans at a deep discount and seeking to profit by forcing a team bankruptcy or restructuring. It was reported recently, for instance, that the Mets now are being protected by restrictions that MLB adopted last year in new baseball team loans that prohibit lenders from reselling the loans to hedge funds without league approval.[7]

League governing documents also often grant broad executive powers to commissioners. For example, MLB Commissioner Bud Selig, citing the "Best Interests of Baseball" clause in the MLB Constitution, claimed to have authority to invalidate the perfected liens of the Rangers' lenders.[8] Selig never attempted to exercise that asserted authority, however, so its legitimacy did not become ripe for consideration in the bankruptcy case.

## Bankruptcy

Bankruptcies of major league franchises are rare, and liquidations even more so. No franchise owner in the four major leagues has ever filed for liquidation under Chapter 7 of the U.S. Bankruptcy Code. The most recent out-of-court liquidation of a professional sports franchise occurred in connection with the merger of the NHL's Cleveland Barons and Minnesota North Stars (since relocated to Dallas and renamed the Dallas Stars) before the 1978-79 season. Moreover, there have been only six instances of a franchise owner in Chapter 11 reorganization proceedings during the past four decades, the bankruptcy of the NHL's Pittsburgh Penguins in 1998 being the first such instance since 1975 (which also concerned the Penguins). The NHL's Buffalo Sabres and Phoenix Coyotes filed in 2003 and 2009, respectively. The other two teams are each from MLB—the Cubs in 2009 and the Rangers in 2010. In addition, the NHL's Ottawa Senators filed for protection under the Companies Creditors' Arrangement Act, Canada's analogue to Chapter 11, in 2003.

Although franchise-owner bankruptcies have been rare, their frequency appears to be increasing, as six have occurred since 1998 and more teams are now reportedly cash-strapped.[9] The inherent tension between the Bankruptcy Code and the broad powers leagues purport to wield under their governing documents and lender consents prompts one to wonder the extent to which those powers are enforceable in bankruptcy. To date, this issue has not been ripe for judicial determination. It appears, indeed, that the leagues have sought to keep the issue beyond the purview of any individual proceeding. Parties in interest in both the Coyotes and Rangers cases (equity in the former, secured creditors in the latter) challenged the untested authority of the leagues to pick and choose owners. In each case, those parties pressed the bankruptcy court to sell the distressed franchise to the highest bidder regardless of any actual or perceived preference by the league for another purchaser. The court in the Coyotes case, in which the highest bidder by a large margin sought to move the team to Southern Ontario, endorsed the NHL's argument that the prior owner did not own rights to a relocatable franchise and thus did not reach the issue of the league's purported authority to approve owners. The NHL eventually bought the Coyotes out of bankruptcy. The creditors in the Rangers case succeeded in forcing an auction of the franchise, but the original prepetition purchaser, who had been pre-cleared by MLB, ultimately prevailed, thereby again avoiding adjudication of the issue.

A court ruling that certain league approval rights violate bankruptcy, antitrust or other laws would curtail the leagues' asserted supremacy. In a showing of league solidarity, the NBA, the NFL and the Office of the Commissioner of Baseball each filed amicus curiae briefs in support of the NHL in the Coyotes case, arguing, in substance, that league controls on ownership are necessary to their leagues' collective success and that an adverse ruling would "severely disrupt the business" of all major professional sports.[10]

## Conclusion

The complex nature of team assets and ownership structures and the constraints imposed by league consents raise many challenges that are peculiar to sports lending. Loans to major league sports franchises nevertheless are attractive commercially because they provide good returns and are secured by collateral that generally has appreciated steadily in value. Experienced sports lenders take comfort that the benefits of relatively low leverage ratios and other league controls, including supporting ongoing operations and success of member franchises and potentially brokering sales of troubled franchises, outweigh the restrictions the leagues require. With a comprehensive understanding of the unique assets, league policies and consent letters, lenders can underwrite sports credits while fully appreciating the limitations on their ability to restructure or dispose of their collateral and loan exposure.

1. Minor league baseball, football, basketball and hockey teams, and teams in other professional sports, also use loans to finance their acquisition and operations, of course, but credit facilities to these franchises tend to be far smaller and less complex than those to teams in the four major North America leagues. Accordingly, we limit our discussion to loans to MLB, NFL, NBA and NHL franchises.
2. Note that because player contracts are personal services contracts, §365(c) of the Bankruptcy Code limits the extent to which they can be assumed in bankruptcy.
3. See U.C.C. §§9-109(d)(8), 9-315 and 9-322.
4. See A.M. Christenfeld and S.W. Melzer, "Insurance Considerations for Secured Lenders, " 227 NYLJ, No. 26 at 5 (Feb. 7, 2002).
5. B. Klayman, "Analysis: Baseball Needs to Strike Out Owners' Debt Issues," Reuters (Feb. 18, 2011), available at http://www.reuters.com/article/2011/02/18/us-baseball-debt-idUSTRE71H4CI20110218.
6. J. Kosman, et al., "De$perate Mets in New Relief Pitch," New York Post, March 1, 2011, at 5.
7. R. Smith and M. Futterman, "MLB Putting Limits on Sale of Team Debt," Wall St. J. (March 15, 2011), available at http://online.wsj.com/article/SB10001424052748703363904576200943072745296.html.
8. R. Sandomir, "Selig Widens 'Best Interests' View in Rangers Bid," N.Y. Times, May 14, 2010, at D6.
9. Klayman, supra note 5.
10. *In re Dewey Ranch Hockey, LLC*, 406 B.R. 30 (Bankr. D. Ariz. 2009).