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VIA FACSIMILE & REGULAR MAIL

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Dear Sirs:

In a letter dated December 15, 2003, Chief Gray requested that the National Indian Gaming Commission (NIGC) review a series of agreements between the Osage Tribe and K&D Gaming (K&D), Oklahoma Gaming Development, LLC (OGD) and Megabingo, Inc. (MBI). The submitted documents are as follows:

1. Memorandum of Understanding between the Tribe and K&D (MOU),

2. Construction Loan Agreement between the Tribe and OGD,

3. Promissory Note from the Tribe to OGD,

4. Security Agreement between the Tribe and OGD,

5. Consulting Agreement between the Tribe and K&D,

6. Development Agreement between the Tribe and K&D,

7. Depository Control Agreement between the Tribe and OGD, and

8. Reel Time Bingo System Agreement (Rental) and Software License between the Tribe and MBI (Lease Agreement)

The NIGC reviews these agreements pursuant to the requirements of the Indian Gaming Regulatory Act (IGRA), 25 U.S.C. § 2701 *et seq*. The purpose of the review is to determine whether the documents constitute a management contract or collateral agreement to a management contract and, therefore, are subject to the Chairman's review and approval under IGRA.

On May 11, 2004, in a meeting with the parties, Chief Gray requested that the Office of General Counsel (OGC) issue an informal letter listing the areas of concern regarding the agreements so that the Tribe could assess the issues of concern and decide whether to revise the agreements prior to the first facility's opening. On May 13, 2004, OGC issued an informal letter identifying specific provisions within the agreements which suggest management control and those provisions which may violate the requirement under IGRA that the Tribe retain the sole proprietary interest in the gaming facilities. The letter noted that OGC had not yet completed its analysis concerning whether or not the agreements constitute a management contract.

On August 2, 2004, NIGC received a request to review an amended series of contracts between the Tribe and K&D, OGD, and MBI. The following documents were submitted:

1. Amended and Restated Construction Loan Agreement between the Tribe and MBI,

2. Amended and Restated Development Agreement between the Tribe and K&D,

3. Amended and Restated Consulting Agreement between the Tribe and K&D,

4. Resolution of the Osage Tribal Council, Resolution No. 31-825,

5. Certificate of Tribe,

6. Amended and Restated Sand Springs Promissory Note between the Tribe and MBI,

7. Amended and Restated Sand Springs Security Agreement between the Tribe and MBI,

8. Amended and Restated North Tulsa Promissory Note between the Tribe and MBI,

9. Amended and Restated North Tulsa Security Agreement between the Tribe and MBI,

10. Amended and Restated Depository Control Agreement between the Tribe, MBI, K&D, and Bank of Oklahoma, N.A.,

11. Termination and Release of Disbursement Agreement,

12. Termination and Release of OGD/Osage Loan Documents,

13. Termination and Release of MBI/OGD Loan Documents,

14. Limited Liability Company Dissolution Agreement concerning OGD,

15. Termination and Release of Participation Agreement,

16. Amended and Restated Reel Time Bingo System Agreement (Rental) and Software License Agreement (Sand Springs), and

17. Amended and Restated Reel Time Bingo System Agreement (Rental) and Software License Agreement (North Tulsa).

The Amended and Restated Development Agreement (Development Agreement) provides for the development, design, construction, equipping, and financing of two Class II and/or Class III gaming facilities in Oklahoma. *See* Development Agreement (dated July 21, 2004) Article 2. Pursuant to this agreement, K&D was to provide two (2) "turn-key" gaming facilities to the Tribe.

OGC reviewed the revised contracts to determine whether they constitute a management contract or collateral agreements to a management contract and are therefore subject to the Chairman's review and approval under IGRA. On November 2, 2004, OGC issued a letter stating that we were not then prepared to conclude that the contracts did not constitute a management contract and we further stated that the contract appeared to violate the sole proprietary interest requirement of 25 U.S.C. §2710(b)(2)(A). *See* Letter from Penny J. Coleman, NIGC Acting General Counsel, to Jim Gray, Principal Chief, Osage Tribal Council, et al., (Nov. 2, 2004).

Mr. Kevin Washburn, attorney for K&D, met with Staff Attorney Andrea Lord to provide a justification for K&D's development fees based upon the gaming expertise of its principals. Ms. Vanya Hogen, also an attorney for K&D, then provided a letter further explaining the fee arrangement. *See* Letter from Vanya Hogen, to Penny Coleman, NIGC Acting General Counsel, (Dec. 10, 2004). In essence, K&D argued that the fee was justified because K&D accepted compensation on a deferred basis, the fee accounts for

the risk assumed by K&D, the fee falls within or below industry norms, and that as a result of K&D's expertise, the total cost of the of the projects were reduced.

On August 11, 2005, the NIGC notified the parties that its review of the development and consulting contracts were on hold pending an investigation into the management of the Tribe's gaming facilities. Letter from Tim Harper, NIGC Region Director, to Chief Gray, Osage Nation (Aug. 11, 2005); Letter from Penny J. Coleman, NIGC Acting General Counsel to Chief Gray, Osage Nation (Aug. 12, 2005). This investigation is currently ongoing.

On May 4, 2006, the NIGC received a copy of the Osage Tribal Gaming Commission's (OTGC) Determination and Orders, dated May 1, 2006, in the Matter of the Status of the Nation's Amended Agreements with K&D Gaming, LLC. The OTGC determined, in part, the following:

1. that the Agreements with K&D, when viewed together, constitute a single agreement related to the management of the Tribe's Tulsa and Sand Spring gaming facilities, and, therefore, required approval of the NIGC Chairman in accordance with 23 U.S.C. §§ 2710(d)(9) and 2711;

2. that the Agreements, collectively and individually are without any legal force or effect until or unless approved by the NIGC Chairman; and

3. that the Agreements give or provide K&D a proprietary interest in the Nation's gaming operations, contrary to IGRA, NIGC regulations, and the Osage Tribal Gaming Ordinance.

See Determination and Order of the Osage Tribal Gaming Commission, page 2 (issued May 1, 2006). However, the Osage Tribal Gaming Commission also concluded that "[t]he effect of the [Osage Tribal Gaming] Commission's determination that the Agreements create in K&D a proprietary interest in the Nation's gaming operation . . . shall be held in abeyance pending concurrence in this determination by the NIGC." *Id.* at 15.

At the present time, we are not prepared to conclude that the contracts do not constitute a management contract and that matter remains under review. However, as detailed fully below, the Development Agreement evidences K&D's proprietary interest in the Tribe's gaming activity, which is contrary to IGRA, NIGC regulations, and the Tribe's gaming ordinance. *See* 25 U.S.C. § 2710 (b)(2)(A); 25 C.F.R. § 522.4(b)(1); Revised Gaming Ordinance of the Osage Tribe (March 16, 2005) § 1.06.

Authority

Among IGRA's requirements for approval of tribal gaming ordinances is that "the Indian tribe will have the sole proprietary interest and responsibility for the conduct of any gaming activity." 25 U.S.C. § 2710(b)(2)(A). Under this section, if any entity other

than a tribe possesses a proprietary interest in the gaming activity, gaming may not take place. NIGC regulations also require that all tribal gaming ordinances include such a provision. 25 C.F.R. § 522.4(b)(1).

"Proprietary interest" is defined in Black's Law Dictionary, 7th Edition (1999), as "the interest held by a property owner together with all appurtenant rights . . . ." An owner is defined as "one who has the right to possess, use and convey something." *Id.* "Appurtenant" is defined as "belonging to; accessory or incident to. . . ." *Id.* Reading these definitions together, proprietary interest creates the right to possess, use and convey something.

Although there are no cases directly on point, courts have defined proprietary interest in a number of contexts. In a criminal tax case, an appellate court discussed what the phrase proprietary interest meant, after the trial court had been criticized for not defining it for jurors, saying:

> It is assumed that the jury gave the phrase its common, ordinary meaning, such as 'one who has an interest in, control of, or present use of certain property.' Certainly, the phrase is not so technical, nor ambiguous, as to require a specific definition.

Evans v. United States, 349 F.2d 653 (5th Cir. 1965). In another tax case, *Dondlinger v. United States*, 1970 U.S. Dist. LEXIS 12693 (D. Neb. 1970), the issue was whether the plaintiff had a sufficient proprietary interest in a wagering establishment to be liable for taxes assessed against persons engaged in the business of accepting wagers. The court observed:

> It is not necessary that a partnership exist. It is only necessary that a plaintiff have some proprietary interest. . . <u>One would have a proprietary interest if he were sharing in or deriving profit from the club</u> as opposed to being a salaried employee merely performing clerical and ministerial duties.

Id. (emphasis added).

The legislative history of IGRA is an additional aid for interpreting the statute's mandate that a tribe "have the sole proprietary interest and responsibility for the conduct of any gaming activity." 25 U.S.C. § 2710(b)(2)(A). The legislative history of the IGRA with respect to "proprietary interest" is scant, stating only that, "the tribe must be the sole owner of the gaming enterprise." S. Rep. 100-446, 1988 U.S.C.C.A.N. 3071-3106, 3078. "Enterprise" is defined as "a business venture or undertaking" in Black's Law Dictionary, 7th Edition (1999). Despite the brevity of this information, the drafters' concept of "proprietary interest" appears to be consistent with the ordinary definition of proprietary

interest, while emphasizing the notion that entities other than tribes are not to share in the ownership of gaming enterprises.

Secondary sources also shed light on the definition of "proprietary interest." In a chapter on joint ventures in American Jurisprudence, 2nd Edition, the difference between having a proprietary interest and being compensated for services is discussed in the context of determining when a joint venture exists:

> Where a contract provides for the payment of a share of the profits of an enterprise, in consideration of services rendered in connection with it, the question is whether it is merely as a measure of compensation for such services or whether the agreement extends beyond that and provides for a proprietary interest in the subject matter out of which the profits arise and for an ownership in the profits themselves. If the payment constitutes merely compensation, the parties bear to each other, generally speaking, the relationship of principal and agent, or in some instances that of employer and employee [footnote omitted]. On the other hand, a proprietary interest or control may be evidence of a joint venture. [footnote omitted]

46 Am. Jur. 2d *Contracts* § 57 (emphasis added).

Consequently, if a joint venture is found to exist it would be further evidence that the tribe did not hold the sole proprietary interest in the gaming operation.

Finally, the preamble to NIGC regulations provides some examples of what contracts may be inconsistent with the sole proprietary interest requirement, but then concludes that "[i]t is not possible for the Commission to further define the term in any meaningful way. The Commission will, however, provide guidance in specific circumstances." 58 Fed. Reg. 5802, 5804 (Jan. 22, 1993).

Determination

In this instance, the Development Agreement accords K&D a proprietary interest in the gaming operation and related operations of the Tribe. Essentially, K&D's proprietary interest in the Tribe's gaming activity derives from the excessive amount of revenue it will be paid from the Tribe's gaming facility relative to the services provided by K&D. Generally, agreement provisions that provide a large percentage of the gaming revenues over a long period of time are evidence that a developer has been granted an equity interest rather than mere compensation for services provided.

The Tribe engaged K&D to be the exclusive developer for two (2) casino projects. K&D was to provide preliminary project evaluation, develop project budgets, select a

contractor, ensure compliance with applicable laws, select the number and mix of gaming devices; monitor and report to the Tribe on construction progress; provide pre-opening consulting services including program development, design and construction consultation, staffing levels, position, licensing and terms of employment, pre-opening publicity and marketing, and cash needs during pre-opening and initial operation of the gaming facilities. *See* Development Agreement §§ 3.1 – 3.7. Essentially, K&D was to provide two (2) turn-key gaming facilities to the Tribe. We understand that the development cost for the two facilities totaled approximately twenty two million dollars ($22,000,000). *See* Letter from Vanya Hogen to Penny Coleman, NIGC Acting General Counsel, at 4 (Dec. 10, 2004).

Pursuant to the Development Agreement, the Tribe is required to pay K&D a development fee equal to seven percent (7%) of the gross revenues of its gaming facilities and related operations, including all restaurants, retail, entertainment operations, and parking, that are ancillary to the gaming facility, for a period of five (5) years.[1] Development Agreement, §§ 5.1 (Development Fee); 1.1 (definitions of "Sand Springs Development Fee," "North Tulsa Development Fee," "Sand Springs Gaming Business," and "North Tulsa Gaming Business"). The development fee is capped at $20,144,000. *See* Development Agreement § 5.1. In addition, the Tribe will reimburse K&D for all out of pocket expenses incurred during the project and will be reimbursed for legal fees incurred in connection with the negotiation of the Development Agreement. *See* Development Agreement § 5.3. Thus, it appears that K&D's development fee will equal approximately one hundred percent (100%) of the actual cost of the developments. Based on income projections for the projects, there is no reason to believe that the $20,144,000 cap will not be reached. *See* Letter from Vanya Hogen to Penny Coleman, NIGC Acting General Counsel, at 6-7 (Dec. 10, 2004). The question then is whether these payments are merely a measure of compensation for the services provided by K&D or whether K&D has obtained a proprietary interest in the Tribe's gaming facilities.

K&D attempts to justify the development fee based, in part, upon the risk of the projects. Letter from Vanya Hogen, to Penny Coleman, NIGC Acting General Counsel (Dec. 10, 2004). K&D agreed to provide certain services to the Tribe and to be compensated from future revenues of the North Tulsa and Sand Springs casinos. *See* Development Agreement § 1.1 (definitions of "Sand Springs Development Fee" and "North Tulsa Development Fee"). K&D assumed the risk of delay and the risk that it would receive no fee should the facilities fail to open. This risk, however, was minimal. The Tribe already held the land in trust for the Sand Springs site. *See* Development Agreement § 8.7. The Tribe further held in fee title the North Tulsa site and the parties were apparently confident that use of such land for gaming would be permissible under IGRA. *Id.* Indian gaming is no longer a new and uncertain venture. The estimation of potential gaming revenue has advanced to the point where market projections can be made with a fairly high level of confidence and such studies were done for the North Tulsa and Sand Spring projects.

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[1] Gross revenues is defined in the Development Agreement as "all revenues of the Gaming Business other than proceeds of borrowing and proceeds from insurance (other than proceeds of business interruption insurance), less all amounts paid out as prizes." See Development Agreement, § 1.1.

K&D further minimized its risk by providing:

> If the North Tulsa Project is terminated at any time and for any reason prior to the North Tulsa Commencement Date, the Tribe agrees to repay all sums advanced by K&D related to the North Tulsa Project whether pursuant to this Development Agreement or in connection herewith, and reasonable amounts for the time of K&D personnel expended to advance the North Tulsa Project.

Development Agreement § 9.5. Consequently, K&D minimized its risk by ensuring that all its costs would be reimbursed should the riskier of the two projects, North Tulsa, fail. Interestingly, the Development Agreement does not contain a similar clause in relation to the Sand Springs site. The absence of a similar clause in relation to the Sand Springs project may reflect the confidence that the parties had that this project would proceed without issue.

Further, income projections for both projects indicate that the parties were reasonably certain that the projects would be financially successful, in fact, so successful that the $20,144,000 cap would be reached in year three (3). *See* Letter from Vanya Hogen to Penny Coleman, NIGC Acting General Counsel (Dec. 10, 2004). K&D also limited its risk by not financing any of the development cost itself. While K&D was to provide for the financing of the two projects, its responsibilities in this area were limited to "assist[ing] the Tribe in locating one or more sources of financing . . . K&D shall have no obligation to fund, guarantee or otherwise provide financial support to the Loan." *See* Development Agreement, Article 2 and § 4.1.

K&D suggests that because of the expertise of its principals, the company was able to minimize the development costs. It argues that comparing the development fee to the development costs is not appropriate. *See* Letter from Vanya Hogen, to Penny Coleman, NIGC Acting General Counsel at 8-9 (Dec. 10, 2004). In fact, K&D suggests that a lower development fee would be hard to find. *Id.* Again, the question is whether K&D's payment is merely a measure of compensation for its services or whether the agreement extends beyond that and provides for a proprietary interest in the Tribe's gaming activity. It simply is not reasonable under any circumstances for a developer to receive a fee in an amount approximately equal to one hundred percent (100%) of actual cost of the project.

Further, the development fee represents pure profit to K&D. All expenses that K&D incurred in advancing the projects have been reimbursed by the Tribe. The Development Agreement provides:

> In addition to the Sand Springs Development Fee and the North Tulsa Development Fee, the Tribe shall reimburse K&D for . . . all out-of-pocket expenses incurred for non-first class air travel, other non-air transportation, lodging, meals, project design, market analysis, long

> distance telephone or fax charges, but only to the extent included in the Development Budget . . . and including the reasonable fees and expenses of legal counsel incurred in connection with the negotiation and documentation of this Agreement and the Consulting Agreement.

Development Agreement § 5.3. The only expense not reimbursed to K&D and its employees related to "permit and license applications and fees required of K&D for K&D to be eligible to render services to the Tribe." *Id.* The development fee is excessive compensation in light of the fact that K&D has already been essentially fully reimbursed by the Tribe for all of its expenses except the minimal cost of doing business with the Tribe.

Generally, developers who do not provide financing for the development receive a small percentage of total development costs. Typically, a development fee is limited to a small percentage of the total development costs. Generally, this amounts to two to five percent (2%-5%) of the total development cost. Ordinarily, a premium for a developer's experience and expertise would be accounted for in the higher rates of the typical development fees. Four to five percent (4%-5%) represents an exceptional fee and adequately compensates the developer's risk. Even assuming that the North Tulsa and Sand Springs casinos contained extraordinary risk and K&D offered expertise, the compensation here is far in excess of the fee we would normally see.

Furthermore, examination of the development fee as a percentage of net revenue provides further support that K&D has obtained a proprietary interest in the Tribe's gaming facilities. Audited financial statements for the fiscal year ending September 30, 2005, indicate that the Tribe's Sand Springs gaming facility grossed $42,185,868, and had net income of $11,174,509. Again, the Tribe is required to pay K&D a development fee equal to seven percent (7%) of the Gross Revenues of its gaming facilities and related operations. *See* Development Agreement § 1.1. The development fee for this fiscal year, $2,953,011, accounts for over twenty six percent (26.4%) of the net revenues for the facility.[2] This percentage of net revenue approaches the maximum level of compensation permitted for management contracts. *See* 25 U.S.C. § 2711(c)(2); 25 C.F.R. § 531.1(i). It is simply not reasonable to expect a developer who is providing no on-going services to the Tribe to receive the same level of compensation typically paid to managers under management contracts.

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[2] K&D received additional compensation under the Consulting Agreement. The Consulting Agreement provides that "K&D shall be entitled to compensation equal to $2,000.00 per person per day." Consulting Agreement, § 9.1. Further, the "Tribe shall reimburse K&D for all expenses reasonably incurred, including, but not limited to, costs related to travel, lodging, copying and faxing." Consulting Agreement, § 9.2. The development fee paid to K&D alone represents over twenty six percent (26%) of the Tribe's net revenues. This number would be significantly higher if we were to factor in the additional compensation K&D received under the Consulting Agreement. We note that the Osage Tribal Enterprise Board has suspended utilization of K&D's consulting services pending NIGC's approval or disapproval of the Agreement. Determination and Order of the Osage Tribal Gaming Commission, page 2 (issued May 1, 2006). Whether the Consulting Agreement constitutes a management contract or is a collateral agreement to a management contract is a matter that remains under review.

Conclusion

We conclude that the Development Agreement bestows a proprietary interest in the gaming operation on K&D, in violation of the IGRA, NIGC regulations and the Tribe's gaming ordinance. This conclusion is based upon the excessive compensation provided to K&D that is not commensurate with K&D's services and cannot be justified by the level or risk associated with the developments. Thus, in this case, the Development Agreement memorializes an ownership interest for K&D in the Tribe's gaming facilities, rather than establishing terms for compensation for services rendered to the Tribe. Accordingly, the Development Agreement is contrary to the public policy underlying the IGRA which prohibits entities other than tribes from having a proprietary interest in a gaming operation. The Development Agreement should be amended to comply with IGRA, NIGC regulations, and the Tribe's gaming ordinance.

If you have any questions, please contact Esther Dittler, Staff Attorney, at (202) 632-7003.

Sincerely,

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