The Commission is providing a copy of this pleading (Accusation, or Statement of Reasons, Statement of Particulars, or Statement of Issues) so the public is as informed as possible of pending administrative proceedings regarding the allegations contained in the pleading. An Accusation, Statement of Issues, Statement of Reasons, or Statement of Particulars is simply an allegation of facts that, if true, may rise to the level of disciplinary action against or denial of a license, registration, work permit, or finding of suitability. The facts contained in the pleadings should not be taken as established or proven. The licensee/applicant will have an opportunity to dispute the allegations in a formal administrative proceeding.

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BEFORE THE

CALIFORNIA GAMBLING CONTROL COMMISSION

STATE OF CALIFORNIA

In the Matter of the Statement of Issues Regarding: **GLCR INC. (GEOW-003379), doing business as TRES LOUNGE AND CASINO (GEGE-001330);** **KYLE KIRKLAND (GEOW-003380); and DANA MESSINA (GEOW-003387)** **184 Main Street** **Watsonville, CA 95076,** **Respondents**.	BGC Case No. BGC-HQ2020-00016SL OAH No. _____ **STATEMENT OF ISSUES**

Complainant alleges:

PARTIES

1. Stephanie Shimazu (Complainant) brings this Statement of Issues solely in her official capacity as the Director of the California Department of Justice, Bureau of Gambling Control (Bureau).

2. Respondent GLCR Inc. (Corporation), license number GEOW-003379, owns, operates, and does business as Tres Lounge and Casino (Casino), which is licensed as a gambling establishment (GEGE-001330) under the Gambling Control Act (Act) (Bus. & Prof. Code, § 19800 et seq.). The Casino is a card room authorized for five tables in Watsonville, California. The Casino currently is not operating.

3. Respondent Kyle Kirkland (Mr. Kirkland), license number GEOW-003380, is a 50-percent owner, as well as an officer and director, of the Corporation and is endorsed[1] on the state gambling license issued to the Corporation.

4. Respondent Dana Messina (Mr. Messina), license number GEOW-003387, is a 50-percent owner, as well as an officer and director, of the Corporation and is endorsed on the state gambling license issued to the Corporation.

5. The Corporation, Mr. Kirkland, and Mr. Messina are referred to collectively as "Respondents" in this Statement of Issues. The California Gambling Control Commission (Commission) initially issued Respondents' licenses pursuant to the Act. Each holds an interim renewal license issued by the Commission. (Cal. Code Regs., tit. 4, § 12035, subd. (a)(1).)

RENEWAL APPLICATIONS AND REFERRAL

6. Respondents submitted applications to renew their licenses.[2] Mr. Kirkland and Mr. Messina seek to renew their licenses as the Corporation's owners, officers, and directors.

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[1] Pursuant to Business and Professions Code section 19851, subdivision (b), individual persons, who "obtain a state gambling license, as required by [the Act] shall not receive a separate license certificate, but the license of every such person shall be endorsed on the license certificate that is issued to the owner of the gambling enterprise."

[2] Under the Act, renewal applications are subject to the Commission's power to deny, revoke, suspend, condition, or limit any license. (Bus. & Prof. Code, § 19876, subd. (a).)

7. On July 25, 2019, the Commission considered Respondents' renewal applications and referred a determination of Respondents' suitability for licensure to a hearing to be held under the Administrative Procedure Act (APA) (Gov. Code, § 11500, et seq.). (Bus. & Prof. Code, § 19825; Cal. Code. Regs, tit. 4, §§ 12056, 12058.) The hearing on Respondents' suitability is to be consolidated with the hearing on *In the Matter of the Statement of Issues Regarding: Club One Casino, Inc., et al.* (BGC Case No. BGC-HQ2015-00018SL) (Club One Matter). Complainant filed the Club One Matter on July 15, 2019.

JURISDICTION, BURDEN OF PROOF, AND COST RECOVERY

8. The Commission has jurisdiction over the operation and concentration of gambling establishments and all persons and things having to do with the operation of gambling establishments. (Bus. & Prof. Code, § 19811, subd. (b).) The Commission has all powers necessary and proper to enable it fully and effectually to carry out the policies and purposes of the Act including denying any application for a license. (Bus. & Prof. Code, § 19824, subd. (b).) The Commission may require matters to be heard and determined in an administrative proceeding under the APA. (Bus. & Prof. Code, § 19825.)

9. Applicants, such as Respondents, have the burden to prove they are qualified to be issued a state gambling license. (Bus. & Prof. Code, § 19856, subd. (a); see also Gov. Code, § 11504.) Failure of either Mr. Kirkland or Mr. Messina to obtain a renewal license will render the Corporation unsuitable for licensure. (Bus. & Prof. Code, §§ 19850, 19852, subd. (a), 19859, subd. (a), 19922.) The Corporation is not eligible for licensing if any of its shareholders, directors, or officers is not licensed. (Bus. & Prof. Code, § 19852, subd. (a).)

10. In a matter involving denial of a license application, the Bureau may recover its costs of investigation and prosecuting the proceeding. (Bus. & Prof. Code, § 19930, subd. (d).)

SUMMARY OF CASE

11. The Act is an exercise of the police power of the State of California intended to protect the public's health, safety and welfare, and shall be liberally interpreted to effectuate that purpose. (Bus. & Prof. Code, § 19971.) The Act protects the public by assuring that only qualified persons are licensed to own, operate, and manage card rooms. (Bus. & Prof. Code, §

19801, subds. (i), (k).) The Act establishes certain criteria for qualification for licensure. (Bus. & Prof. Code, § 19857.) The failure to establish clearly these criteria requires mandatory denial of a license application. (Bus. & Prof. Code, § 19859, subd. (a).) The Act requires an applicant for licensing to make full and true disclosure to the Bureau and the Commission of all information necessary to carry out the state's policies relating to licensing and control of gambling. (Bus. & Prof. Code, § 19866.)

12. This proceeding seeks to deny Respondents' renewal applications and the recovery of the Bureau's costs. By cumulative conduct spanning a number of years, Mr. Kirkland and Mr. Messina demonstrated that they do not satisfy the criteria for qualification and, therefore, are not suitable for licensure. Specifically, Mr. Kirkland and Mr. Messina engaged in the conduct alleged in the Statement of Issues filed in the Club One Matter, which is attached as Exhibit A and incorporated herein in its entirety. If Mr. Kirkland or Mr. Messina is unqualified for, or disqualified from, licensure as alleged in the Club One Matter, he is unqualified for, or disqualified from, licensure as the Corporation's owner, officer, or director.

FIRST CAUSE FOR DENIAL

(Unqualified for Lack of Good Character, Honesty, and Integrity)

13. The cumulative facts and conduct alleged in the Club One Matter demonstrate that Mr. Kirkland and Mr. Messina are not qualified for licensure. Accordingly, the Commission should deny Respondents' renewal applications. Mr. Kirkland and Mr. Messina cannot establish they are persons of good character, honesty, and integrity. (Bus. & Prof. Code, §§ 19856, 19857, subd. (a), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

SECOND CAUSE FOR DENIAL

(Unqualified for Posing a Threat to the Public Interest and Effective Regulation)

14. The cumulative facts and conduct alleged in the Club One Matter demonstrate that Mr. Kirkland and Mr. Messina are not qualified for licensure. Accordingly, the Commission should deny Respondents' renewal applications. Mr. Kirkland and Mr. Messina's prior activities show that they pose a threat to the public interest or to the effective regulation and control of

controlled gambling. (Bus. & Prof. Code, §§ 19856, 19857, subd. (b), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

THIRD CAUSE FOR DENIAL

(Unqualified for Dangers of Unsuitable or Unfair Practices)

15. The cumulative facts and conduct alleged in the Club One Matter demonstrate that Mr. Kirkland and Mr. Messina are not qualified for licensure. Accordingly, the Commission should deny Respondents' renewal applications. Mr. Kirkland and Mr. Messina's prior activities show that they create or enhance the dangers of unsuitable or unfair practices, methods, and activities in carrying on the business of, and the financial arrangements incidental to, controlled gambling. (Bus. & Prof. Code, §§ 19856, 19857, subd. (b), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

PRAYER

WHEREFORE, Complainant respectfully requests that a hearing be held on the matters herein alleged, and that following the hearing, the Commission issue a decision:

1. Denying the application of Respondent Kyle Kirkland to renew his state gambling license number GEOW-003380;

2. Denying the application of Respondent Dana Messina to renew his state gambling license number GEOW-003387;

3. Denying the application of Respondent GLCR Inc. to renew its state gambling license number GEOW-003379;

4. Awarding the Bureau the costs of investigation and costs of bringing this Statement of Issues before the Commission, pursuant to Business and Professions Code section 19930, subdivisions (d) and (f), in a sum according to proof; and

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/ / /

5. Taking such other and further action as the Commission may deem appropriate.

Dated: June 30, 2020

STEPHANIE SHIMAZU, Bureau Director
Bureau of Gambling Control
California Department of Justice

Complainant

EXHIBIT A

STATEMENT OF ISSUES

In the Matter of the Statement of Issues Regarding: Club One Casino, Inc., et al.
(BGC Case No. BGC-HQ2015-00018SL)

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BEFORE THE

CALIFORNIA GAMBLING CONTROL COMMISSION

STATE OF CALIFORNIA

In the Matter of the Statement of Issues Regarding: **CLUB ONE CASINO, INC. (GEGE-001121), doing business as CLUB ONE CASINO;** **KYLE KIRKLAND (GEOW-003177); and DANA MESSINA (GEOW-003175)** **1300 Van Ness Avenue** **Fresno, CA 93721** **Respondents**.	BGC Case No. BGC-HQ2015-00018SL OAH No. _____ **STATEMENT OF ISSUES**

Complainant alleges:

PARTIES

1. Stephanie Shimazu (Complainant) brings this Statement of Issues solely in her official capacity as the Director of the California Department of Justice, Bureau of Gambling Control (Bureau).

2. Club One Casino, Inc. (Respondent Corporation) is licensed as a gambling enterprise (GEGE-001121) under the Gambling Control Act (Act) (Bus. & Prof. Code, § 19800 et seq.). Respondent Corporation does business as Club One Casino (Club One), which is a 51-table card room located 1300 Van Ness Avenue in Fresno, California.

3. Respondent Kyle Kirkland (Respondent Kirkland) is an officer, director, and a 50-percent shareholder of Respondent Corporation. Respondent Kirkland, license number GEOW-003177, is endorsed[1] on Club One's state gambling license.

4. Respondent Dana Messina (Respondent Messina) is an officer, director, and a 50-percent shareholder of Respondent Corporation. Respondent Messina, license number GEOW-003175, is endorsed on Club One's state gambling license.

5. Respondent Corporation, Respondent Kirkland, and Respondent Messina are referred to collectively as "Respondents" in this Statement of Issues. The California Gambling Control Commission (Commission) initially issued Respondents' licenses pursuant to the Act. Each Respondent holds an interim renewal license issued by the Commission. (Cal. Code Regs., tit. 4, § 12035, subd. (a)(1).)[2]

[1] Pursuant to Business and Professions Code section 19851, subdivision (b), individual persons, who "obtain a state gambling license, as required by [the Act] shall not receive a separate license certificate, but the license of every such person shall be endorsed on the license certificate that is issued to the owner of the gambling enterprise."

[2] Appendix A quotes the statutes and regulations applicable to this Statement of Issues in pertinent part.

THE PENDING RENEWAL APPLICATIONS[3]

6. On March 2, 2015, the Bureau received an application for renewal of a state gambling license from Respondent Corporation.

7. On March 2, 2015, Respondent Kirkland submitted an application to renew his license.

8. On February 27, 2015, Respondent Messina submitted an application to renew his license.

9. On or about May 15, 2015, the Bureau issued a Gambling Establishment and Owner Application Review - Level II for Respondents' applications to renew their licenses (renewal applications). In that review, the Bureau identified as an area of concern a New York Supreme Court post-trial decision and order (New York Order), filed October 21, 2014, that brought into question the character, honesty, and integrity of Respondents Kirkland and Messina. Appendix B is a true and complete copy of the New York Order.

10. On June 25, 2015, the Commission considered Respondents' renewal applications and referred a determination of Respondents' suitability for licensure to a hearing to be held under the Administrative Procedure Act (APA) (Gov. Code, § 11500, et seq.).[4] (Bus. & Prof. Code, § 19825; Cal. Code. Regs, tit. 4, §§ 12056, 12058.)

[3] Under the Act, renewal applications are subject to the Commission's power to deny, revoke, suspend, condition, or limit any license. (Bus. & Prof. Code, § 19876, subd. (a).)

[4] When the Commission referred this matter to a suitability hearing in 2015, the referral included Respondent Corporation and the Club One Acquisition Corporation (COAC), which were both on the state gambling enterprise license (GEGE- 001121), as well as Haeg Kelegian (Mr. Kelegian), George Sarantos (Mr. Sarantos), Respondent Kirkland, and Respondent Messina as endorsees for COAC. Respondent Kirkland and Respondent Messina were also endorsees for Respondent Corporation. However, in a subsequent Chapter 11 bankruptcy reorganization, COAC merged with Respondent Corporation, leaving Respondent Corporation as the sole entity emerging from the bankruptcy and Respondent Kirkland and Respondent Messina as its only shareholders. Accordingly, this Statement of Issues pertains only to the suitability for licensure of Respondent Corporation, as the gambling enterprise, and Respondent Kirkland and Respondent Messina, as its shareholders, officers, and directors.

JURISDICTION, BURDEN OF PROOF, AND COST RECOVERY

11. The Commission has jurisdiction over the operation and concentration of gambling establishments and all persons and things having to do with the operation of gambling establishments. (Bus. & Prof. Code, § 19811, subd. (b).) The Commission has all powers necessary and proper to enable it fully and effectually to carry out the policies and purposes of the Act including denying any application for a license. (Bus. & Prof. Code, § 19824, subd. (b).) The Commission may require matters to be heard and determined in an administrative proceeding under the APA. (Bus. & Prof. Code, § 19825.)

12. An applicant, such as Respondents, has the burden to prove they are qualified to be issued a state gambling license. (Bus. & Prof. Code, § 19856, subd. (a); see also Gov. Code, § 11504.) Failure of any Respondent to obtain a renewal license will render Club One unsuitable for licensure. (Bus. & Prof. Code, §§ 19850, 19852, subd. (a), 19859, subd. (a), 19922.) Respondent Corporation is not eligible for licensing if either of its shareholders, directors, or officers is not licensed. (Bus. & Prof. Code, § 19852, subd. (a).)

13. In a matter involving denial of a license application, the Bureau may recover its costs of investigation and prosecuting the proceeding. (Bus. & Prof. Code, § 19930, subd. (d).)

SUMMARY OF CASE

14. The Act is an exercise of the police power of the State of California intended to protect the public's health, safety and welfare, and shall be liberally interpreted to effectuate that purpose. (Bus. & Prof. Code, § 19971.) The Act protects the public by assuring that only qualified persons are licensed to own, operate, and manage card rooms. (Bus. & Prof. Code, § 19801, subds. (i), (k).) The Act establishes certain criteria for qualification for licensure. (Bus. & Prof. Code, § 19857.) The failure to establish clearly these criteria requires mandatory denial of a license application. (Bus. & Prof. Code, § 19859, subd. (a).) The Act requires an applicant for licensing to make full and true disclosure to the Bureau and the Commission of all information necessary to carry out the state's policies relating to licensing and control of gambling. (Bus. & Prof. Code, § 19866.)

15. This proceeding seeks to deny Respondents' renewal applications and the recovery of the Bureau's costs. By cumulative conduct spanning a number of years, Respondents demonstrated that they do not satisfy the criteria for qualification and, therefore, are not suitable for licensure. Specifically, Respondents engaged in conduct that, among other things:

a. Breached the implied covenant of good faith and fair dealing in connection with their initial acquisition of and continuing control over Club One;

b. Endangered Club One's financial viability and continued operations as a going concern;

c. Led to a bankruptcy proceeding and reorganization that forced certain creditors and shareholders to take substantially reduced payments on liabilities that Respondents created and that inured to Respondents' benefit;

d. Was found by an arbitrator to be less than honest;

e. Was found by an arbitrator to have given false testimony;

f. Was found by a judge to be less than honest;

g. Misled or misrepresented information to the Commission; and

h. Threatened the public trust and perception that card rooms are operated in a financially responsible and honest manner.

FACTUAL BACKGROUND

16. Respondent Kirkland and Respondent Messina formerly held securities licenses. In 1994, they organized an investment advisory firm that assisted clients with arranging leveraged buyouts and corporate financing. Before their investments in Club One, Respondent Kirkland and Respondent Messina, individually or together, provided investment advisory services to certain California card rooms. Respondent Kirkland and Respondent Messina hold themselves out to be sophisticated businesspersons.

A. Securities Licensing Sanctions Against Respondent Kirkland

17. On September 28, 2001, the U.S. Securities and Exchange Commission (SEC) entered an Order Instituting Public Administrative and Cease-and-Desist Proceeding, Making Findings and Imposing Sanctions and Cease-and-Desist Order (SEC Order) against Respondent

Kirkland. There, pursuant to a settlement, the SEC found that Respondent Kirkland provided misleading market values of securities to a mutual fund and an offshore fund. He accepted a three-year bar from the securities industry and agreed to pay a $30,000 fine. Appendix C is a true and complete copy of the SEC Order.

B. Acquisition of Club One and Failure To Pay Certain Contractual Obligations

18. Respondent Corporation was formed in 1994. In July 2006, Respondent Corporation's then shareholders, Mr. Sarantos and Elaine Long (Ms. Long) (collectively, Sellers), entered into a letter of intent with Respondent Kirkland and Respondent Messina for the purchase and sale of Respondent Corporation's stock for $27 million. On February 24, 2007, the parties signed an Agreement for Purchase and Sale of Stock (PSA).

19. The stock transaction closed on February 22, 2008. Before the closing, Respondent Kirkland and Respondent Messina conducted extensive due diligence, which included unrestricted opportunities to inspect Club One's physical and financial condition. They had full access to Respondent Corporation's books and records.

20. In the stock transaction, COAC acquired Sellers' stock in Respondent Corporation for $27 million. After the closing, Respondent Kirkland and Respondent held 80 percent of COAC's stock; Mr. Sarantos held 17 percent; and Mr. Kelegian held three percent. The stock transaction was highly leveraged. COAC borrowed $22.5 million (Senior Loan), which Respondent Corporation agreed to pay and was secured by Club One's assets, from an investment lender. Sellers held unsecured notes (Seller Notes) payable by Respondent Corporation totaling $5 million. The Senior Loan was payable February 22, 2012. The Seller Notes were subordinate to the Senior Loan and payable on February 22, 2015. Respondent Kirkland and Respondent Messina, jointly and severally, personally guaranteed $7 million of the Senior Loan.

21. The PSA provided for a purchase price adjustment to be calculated after the stock transaction closed. Respondent Kirkland and Respondent Messina disagreed with Sellers regarding the amount of the purchase price adjustment. Sellers claimed the adjustment should be approximately $1 million; Respondent Kirkland and Respondent Messina eventually claimed the adjustment should be approximately $23,000. Respondent Messina, however, advised the lender

on the Senior Loan: "We are being as aggressive as possible . . . and will hopefully save a few dollars. . . . Originally we expected to pay out $1.5 million in the [adjustment] but are working hard to keep the number below $1 million."

22. COAC did not pay the purchase price adjustment even though Club One had sufficient cash to pay. On December 30, 2008, Sellers filed demands in arbitration seeking approximately $1 million as a purchase price adjustment. Rather than pay, Respondent Kirkland and Respondent Messina caused COAC to assert counterclaims in the arbitration. On April 12, 2011, the arbitrator issued an interim award in favor of Sellers, finding that the proper adjustment was approximately $1 million and denying COAC's counterclaims. On June 27, 2011, the arbitrator awarded Sellers pre-award interest totaling approximately $313,000, attorney fees of approximately $441,000, and approximately $140,000 in costs. On July 8, 2011, the arbitrator issued the final award.

23. In the interim award, the arbitrator determined that COAC's counterclaim that Sellers failed to disclose or misrepresented certain information lacked merit. The arbitrator specifically found, among other things, that COAC, through Respondent Kirkland, Respondent Messina, and their agents, "could not have reasonably relied . . . because it either knew, or in the exercise of even minimal due diligence should have known, of any such material facts."

24. By refusing to pay an obligation that Mr. Messina expected to be $1.5 million, Mr. Kirkland and Mr. Messina had caused COAC to increase a $1 million obligation into a liability of nearly $1.9 million on which interest accrued at $227.00 per day.

C. <u>Arbitral and Judicial Findings Regarding Credibility and Honesty</u>

25. In the interim award, the arbitrator called the credibility of Respondent Kirkland and Respondent Messina into question:

> The credibility of their assertions is also brought into question . . . i.e. evasive and inconsistent testimony under oath in the hearings, grossly inaccurate and misleading statements made under oath in a pre-hearing declaration . . . , and questionable conduct in submitting a re-engineered financial statement to [COAC's] lender.

26. Rather than pay the award and consequent judgment, Respondent Kirkland and Respondent Messina caused COAC to file an action in the New York Supreme Court to block enforcement of the award and judgment. (*Club One Acquisition Corporation v. George Sarantos and Elaine Long, Defendants and KMGI, Inc., Plaintiff-Intervenor*, NYSC Case Number 650049/2012 (New York Litigation).) In the New York Litigation, the court entered the New York Order after a non-jury trial. The court determined that COAC breached the covenant of good faith and fair dealing implied in the PSA.

27. The New York Order made findings regarding the character, honesty, and integrity of Respondent Kirkland and Respondent Messina. The findings included, among other things, the following:

a. "[Respondent] Kirkland's attempt at trial to justify making an adjustment to the [Purchase Price Adjustment] for such taxes was disingenuous." (New York Order, p. 19.)

b. "The counterclaim [in the arbitration] was largely bogus . . . ." (New York Order, p. 19.)

c. "In his affidavit presented at trial . . . [Respondent] Kirkland states misleadingly that 'the Defendants represented in the [PSA] that (a) [t]he financial statements the [sic] provided to me and Mr. Messina were "prepared in accordance with generally accepted accounting principles" and "true, complete and correct in all material respects . . . ."' In fact, the introductory clause to the sentence from which the quoted language was extracted shows that was not the understanding of the parties." (New York Order, p. 20.)

d. "To the extent the counterclaim in arbitration asserted otherwise, it was baseless." (New York Order, p. 21.)

e. ". . . [COAC] elected to 'set-off' its payment obligations by asserting a meritless counterclaim in violation of its implied pledge not to 'do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract' [citation]." (New York Order, p. 21.)

f. ". . . [COAC] elected to be 'as aggressive as possible' . . . and to breach . . . its contractual obligations. Through a series of subterfuges and evasions, [COAC] and its principals [Respondent Kirkland and Respondent Messina] have succeeded in evading payment properly owed to [Sellers] as of April 2008." (New York Order, p. 21.)

g. "After it became evident that [COAC] would not prevail in the arbitration, [Respondent] Messina and [Respondent] Kirkland charted a course of conduct designed to shield themselves from having to pay. Their acts of evasion and obfuscation included (1) pre-payment of principal on the Senior Loan in order to reduce the amount of cash available . . . to pay an expected adverse arbitration award . . . ; (2) successful lobbying of [the Senior Loan holder to] issue a notice designed to shield [COAC] from having to pay the arbitration award . . . ; and (3) failure of [Respondent] Kirkland and [Respondent] Messina to take reasonable measures to avoid a maturity default on February 23, 2012 followed by their purchase of the Senior Loan and paying themselves 'default interest' on the Senior Loan . . . ." (New York Order, pp. 21-22.)

h. "[Respondent] Kirkland testified that the [default] notice was prepared '[a]t the lenders' request' . . . . This testimony was false . . . ." (New York Order, p. 22, fn. 15.)

i. "[Respondent] Messina and [Respondent] Kirkland . . . (1) orchestrated the breach of the PSA; (2) enlisted the [Senior Loan] Lender's aid to shield themselves; and (3) are now directing the joint effort of [COAC] and KMGI to further delay payment . . . ." (New York Order, p. 24.)

28. Rather than perform their obligations as determined in the New York Litigation, Respondent Kirkland and Respondent Messina caused COAC to file an appeal on November 11, 2014. In audited financial statements for the year ending December 31, 2014, Respondent Corporation reported that the accrued interest on the arbitration award and consequent judgment exceeded $975,000. The total liability reported from the arbitration award, consequent judgment,

and New York Order exceeded $2.6 million. Additionally, attorney fees incurred by COAC in prosecuting the case exceeded $1.4 million.

D. Default on and Acquisition of the Senior Loan

29. In January 2011, Respondent Kirkland and Respondent Messina formed KMGI, Inc. to raise capital to refinance or acquire the Senior Loan, which as alleged above was payable on February 22, 2012. Respondent Kirkland and Respondent Messina were, and continue to be, that corporation's only shareholders.

30. In July 2011, using a form of notice drafted by COAC's attorneys, the holder of the Senior Loan notified the Sellers that the arbitration award was subject to the subordination agreement.

31. In January 2012, the holder of the Senior Loan gave notice to Respondent Corporation that the Sellers' judgment and writ of execution were events of default. The holder of the Senior Loan exercised its right to convert – i.e., increase – the annual interest rate to 16.5 percent.

32. On February 22, 2012, Respondent Corporation failed to pay the Senior Loan, constituting another event of default.

33. On April 11, 2012, after obtaining the Commission's approval, KMGI, Inc. acquired the Senior Loan. Respondent Kirkland and Respondent Messina chose this alternative to maintain the seniority of the Senior Loan over the Seller Notes and to avoid the need for the consent of Messrs. Sarantos and Kelegian to a particular transaction. Respondent Kirkland and Messina caused KMGI, Inc. to release them of their personal guarantees on the Senior Loan and to continue assessing interest at 16.5 percent. KMGI, Inc. paid $14.4 million to acquire the Senior Loan, which was the outstanding amount owed. Shortly thereafter, Respondent Corporation reduced the unpaid principal by paying $400,000 to KMGI, Inc.

E. Respondent Corporation Failed To Pay Principal and Interest on its Indebtedness

34. From and after KMGI, Inc.'s acquisition of the Senior Loan, annual interest accrued in amounts ranging from approximately $2.3 million to approximately $3.9 million. By

December 31, 2015, principal and accrued interest payable on the Senior Loan totaled nearly $24.9 million – more than $10 million than the amount owed in April 2012.

35. Following the notices of default on the Senior Loan, Respondent Corporation ceased paying interest on the Seller Notes, which accrued at the rate of $500,000 to $600,000 annually. Respondent Corporation failed to pay the Seller Notes at the February 22, 2015 maturity.

F. Auditors' Going Concern Qualifications

36. Respondents' conduct alleged in this Statement of Issues affected Club One's ostensible financial viability as an operating card room.

a. Club One reported losses ranging between $3.7 million and $11.1 million for the years 2012 through 2015. A substantial portion of the reported losses was accrued, but unpaid, interest on the Senior Loan and the Seller Notes. The losses reported for 2012 and 2013 exceeded 89 percent of Club One's revenues derived from offering and providing card games.

b. Club One's liabilities exceeded its current and tangible assets in amounts ranging between $23.8 million and $34.4 million for the years 2012 through 2015. These deficits were two to three times Club One's annual revenues derived from offering and providing card games.

37. Beginning with audited financial statements for the year ending December 31, 2011, Respondent Corporation's auditors reported doubt about its ability to continue as a going concern. The financial statements for the 2012, 2013, 2014, and 2015 reported conditions that "raise substantial doubt about the [Respondent Corporation's] ability to continue as a going concern."

G. Bankruptcy Reorganization to Benefit Respondents

38. On October 14, 2015, Respondent Corporation and COAC filed a bankruptcy reorganization proceeding in the United States Bankruptcy Court.

39. The bankruptcy court confirmed a reorganization plan, which the Commission approved on August 25, 2016. Under the reorganization plan, Respondent Corporation and

COAC merged, and Respondent Corporation emerged as the surviving corporation. On September 9, 2016, Respondent Kirkland and Respondent Messina purchased all Respondent Corporation's outstanding shares.

40. Under the reorganization plan, Respondent Corporation eliminated obligations to Sellers, and Respondent Kirkland and Respondent Messina eliminated the minority shareholders.

a. The Senior Loan held by KMGI, Inc. was reduced to $7 million. The remaining principal and accrued interest totaling more than $17 million were discharged.

b. Sellers were paid a total of $3 million to (i) settle approximately $10.5 million in obligations arising from the arbitration, consequent judgment, and New York Litigation and the Seller Notes and (ii) extinguish Mr. Sarantos's 17-percent shareholder interest in COAC.

c. Accrued management fees of approximately $2 million payable to an affiliate of Respondent Kirkland and Respondent Messina were discharged.

d. Approximately $1.1 million in attorney fees owed from the arbitration and New York Litigation was discharged by the payment of $350,000.

e. Mr. Kelegian's three-percent shareholder interest in COAC was extinguished.

f. As part of a global settlement with Sellers, the New York Order was to be, and ultimately was, vacated.

H. <u>Misleading or Misrepresented Information to the Commission</u>

41. At a September 22, 2011 Commission meeting, Respondent Kirkland stated to the Commission that KMGI, Inc. was a vehicle for him and Respondent Messina to pay off or pay down the Senior Loan and address other debts including the arbitration award and the Seller Notes. The statements were either misleading or misrepresented information. In truth, KMGI, Inc. did not pay off or pay down the Senior Loan. Respondent Kirkland and Respondent Messina rejected that as an alternative and elected to purchase the Senior Loan instead. In truth, Respondent Corporation failed to pay principal and interest on its indebtedness on the Senior Loan and the Seller Notes. In truth, Respondent Kirkland and Respondent Messina caused COAC to file the New York Litigation to continue to avoid fulfilling obligations under the PSA.

42. At a March 8, 2012 Commission meeting, Respondent Kirkland stated to the Commission that the Senior Loan holder "told us . . . [it] would like that we wouldn't pay that any longer." This was misleading. In truth, COAC attorneys had drafted the notice, and Respondents had been found to have "enlisted" the Senior Loan holder's aid to avoid paying Sellers. Respondent Messina stated to the Commission that after acquiring the Senior Loan, changes potentially would be made. This was either misleading or misrepresented information. In truth, after acquiring the Senior Loan, no changes were made other than releasing Respondent Kirkland and Respondent Messina of their personal guarantees. Respondents' agent stated to the Commission, "The goal certainly is to pay, not only the arbitration award in a timely fashion, but also the other notes involved with us." This was either misleading or misrepresented information. In truth, Respondent Kirkland and Respondent Messina caused COAC to pursue the New York Litigation to continue to avoid fulfilling obligations under the PSA.

43. At a September 27, 2012 Commission meeting, Respondents' agent represented to the Commission that Club One was "one of the most fiscally responsible" card rooms in California. This was misleading or misrepresented information. In truth, Respondent Corporation had defaulted on the Senior Loan, failed to pay principal and interest on its indebtedness on the Senior Loan and the Seller Notes, and raised substantial doubt about its ability to continue as a going concern. Respondent Kirkland stated to the Commission that he was estimating "a couple million dollars" in liability in employment litigation. This was either misleading or misrepresented information. In truth, the audited financial statement for the year ending December 31, 2012, informed with respect to employment litigation: (a) "management" estimated the maximum liability on insured claims to be $100,000; (b) legal counsel estimated uninsured claims "could range from $0 to $700,000"; and (c) management believed the outstanding claims "will be defeated."

FIRST CAUSE FOR DENIAL

(Unqualified for Lack of Good Character, Honesty, and Integrity)

44. The cumulative facts and conduct alleged in paragraphs 16 to 43 above demonstrate that Respondents are not qualified for licensure. Accordingly, the Commission should deny their renewal applications. Respondents cannot establish they are persons of good character, honesty, and integrity. (Bus. & Prof. Code, §§ 19856, 19857, subd. (a), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

SECOND CAUSE FOR DENIAL

(Unqualified for Posing a Threat to the Public Interest and Effective Regulation)

45. The cumulative facts and conduct alleged in paragraphs 16 to 43 above demonstrate that Respondents are not qualified for licensure. Accordingly, the Commission should deny their renewal applications. Respondents' prior activities show that they pose a threat to the public interest or to the effective regulation and control of controlled gambling. (Bus. & Prof. Code, §§ 19856, 19857, subd. (b), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

THIRD CAUSE FOR DENIAL

(Unqualified for Dangers of Unsuitable or Unfair Practices)

46. The cumulative facts and conduct alleged in paragraphs 16 to 43 above demonstrate that Respondents are not qualified for licensure. Accordingly, the Commission should deny their renewal applications. Respondents' prior activities show that they create or enhance the dangers of unsuitable or unfair practices, methods, and activities in carrying on the business of, and the financial arrangements incidental to, controlled gambling. (Bus. & Prof. Code, §§ 19856, 19857, subd. (b), 19859, subd. (a), 19866; see also Cal. Code Regs., tit. 4, §§ 12346, subd. (a)(1), 12568, subd. (c)(3) & (4).)

PRAYER

WHEREFORE, Complainant respectfully requests that a hearing be held on the matters herein alleged, and that following the hearing, the Commission issue a decision:

1. Denying the application of Respondent Club One Casino, Inc. to renew its state gambling license number GEGE-001121;

2. Denying the application of Respondent Kyle Kirkland to renew his state gambling license number GEOW-003177;

3. Denying the application of Respondent Dana Messina to renew his state gambling license number GEOW-003175;

4. Awarding Complainant the costs of investigation and costs of bringing this Statement of Issues before the Commission, pursuant to Business and Professions Code section 19930, subdivisions (d) and (f), in a sum according to proof; and

5. Taking such other and further action as the Commission may deem appropriate.

Dated: July 10, 2019

STEPHANIE SHIMAZU, Bureau Director
Bureau of Gambling Control
California Department of Justice
Complainant

APPENDIX A

1. Business and Professions Code, section 19801 provides, in part:

* * *

> (g) Public trust that permissible gambling will not endanger public health, safety, or welfare requires that comprehensive measures be enacted to ensure that gambling is free from criminal and corruptive elements, that it is conducted honestly and competitively, and that it is conducted in suitable locations.
>
> (h) Public trust and confidence can only be maintained by strict and comprehensive regulation of all persons, locations, practices, associations, and activities related to the operation of lawful gambling establishments and the manufacture and distribution of permissible gambling equipment.
>
> (i) All gambling operations, all persons having a significant involvement in gambling operations, all establishments where gambling is conducted, and all manufacturers, sellers, and distributors of gambling equipment must be licensed and regulated to protect the public health, safety, and general welfare of the residents of this state as an exercise of the police powers of the state.
>
> * * *
>
> (k) In order to effectuate state policy as declared herein, it is necessary that gambling establishments, activities, and equipment be licensed, that persons participating in those activities be licensed or registered, that certain transactions, events, and processes involving gambling establishments and owners of gambling establishments be subject to prior approval or permission, that unsuitable persons not be permitted to associate with gambling activities or gambling establishments, and that gambling activities take place only in suitable locations. Any license or permit issued, or other approval granted pursuant to this chapter, is declared to be a revocable privilege, and no holder acquires any vested right therein or thereunder.

2. Business and Professions Code, section 19805 provides, in part:

* * *

> (j) "Finding of suitability" means a finding that a person meets the qualification criteria described in subdivisions (a) and (b) of Section 19857, and that the person would not be disqualified from holding a state gambling license on any of the grounds specified in Section 19859.
>
> * * *

(m) "Gambling enterprise" means a natural person or an entity, whether individual, corporate, or otherwise, that conducts a gambling operation and that by virtue thereof is required to hold a state gambling license under this chapter.

* * *

(p) "Gambling license" or "state gambling license" means any license issued by the state that authorizes the person named therein to conduct a gambling operation.

* * *

(ad) "Owner licensee" means an owner of a gambling enterprise who holds a state gambling license.

* * *

(aj) "Renewal license" means the license issued to the holder of an initial license that authorizes the license to continue beyond the expiration date of the initial license.

3. Business and Professions Code section 19811, subdivision (b), provides:

Jurisdiction, including jurisdiction over operation and concentration, and supervision over gambling establishments in this state and over all persons or things having to do with the operation of gambling establishments is vested in the commission.

4. Business and Professions Code section 19823 provides:

(a) The responsibilities of the commission include, without limitation, all of the following:

(1) Assuring that licenses, approvals, and permits are not issued to, or held by, unqualified or disqualified persons, or by persons whose operations are conducted in a manner that is inimical to the public health, safety, or welfare.

(2) Assuring that there is no material involvement, directly or indirectly, with a licensed gambling operation, or the ownership or management thereof, by unqualified or disqualified persons, or by persons whose operations are conducted in a manner that is inimical to the public health, safety, or welfare.

(b) For the purposes of this section, "unqualified person" means a person who is found to be unqualified pursuant to the criteria set

forth in Section 19857, and "disqualified person" means a person who is found to be disqualified pursuant to the criteria set forth in Section 19859.

5. Business and Professions Code section 19824 provides, in part:

> The commission shall have all powers necessary and proper to enable it fully and effectually to carry out the policies and purposes of this chapter, including, without limitation, the power to do all of the following:
>
> * * *
>
> (b) For any cause deemed reasonable by the commission, deny any application for a license, permit, or approval provided for in this chapter or regulations adopted pursuant to this chapter, limit, condition, or restrict any license, permit, or approval, or impose any fine upon any person licensed or approved. The commission may condition, restrict, discipline, or take action against the license of an individual owner endorsed on the license certificate of the gambling enterprise whether or not the commission takes action against the license of the gambling enterprise.
>
> * * *
>
> (d) Take actions deemed to be reasonable to ensure that no ineligible, unqualified, disqualified, or unsuitable persons are associated with controlled gambling activities.

6. Business and Professions Code, section 19825, provides:

> The commission may require that any matter that the commission is authorized or required to consider in a hearing or meeting of an adjudicative nature regarding the denial, suspension, or revocation of a license, permit, or finding of suitability, be heard and determined in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 or Title 2 of the Government Code.

7. Business and Professions Code section 19850 provides:

> Every person who, either as owner, lessee, or employee, whether for hire or not, either solely or in conjunction with others, deals, operates, carries on, conducts, maintains, or exposes for play any controlled game in this state, or who receives, directly or indirectly, any compensation or reward, or any percentage or share of the money or property played, for keeping, running, or carrying on any controlled game in this state, shall apply for and obtain from the commission, and

shall thereafter maintain, a valid state gambling license, key employee license, or work permit, as specified in this chapter. In any criminal prosecution for violation of this section, the punishment shall be as provided in Section 337j of the Penal Code.

8. Business and Professions Code section 19851 provides:

(a) The owner of a gambling enterprise shall apply for and obtain a state gambling license. The owner of a gambling enterprise shall be known as the owner-licensee.

(b) Other persons who also obtain a state gambling license, as required by this chapter, shall not receive a separate license certificate, but the license of every such person shall be endorsed on the license certificate that is issued to the owner of the gambling enterprise.

9. Business and Professions Code section 19852 provides, in part:

Except as provided in Section 19852.2, an owner of a gambling enterprise that is not a natural person shall not be eligible for a state gambling license unless each of the following persons individually applies for and obtains a state gambling license:

(a) If the owner is a corporation, then each officer, director, and shareholder, other than a holding or intermediary company, of the owner. The foregoing does not apply to an owner that is either a publicly traded racing association or a qualified racing association

10. Business and Professions Code, section 19856 provides, in part:

(a) Any person who the commission determines is qualified to receive a state license, having due consideration for the proper protection of the health, safety, and general welfare of the residents of the State of California and the declared policy of this state, may be issued a license. The burden of proving his or her qualifications to receive any license is on the applicant.

(b) An application to receive a license constitutes a request for a determination of the applicant's general character, integrity, and ability to participate in, engage in, or be associated with, controlled gambling.

(c) In reviewing the application for any license, the commission shall consider whether issuance of the license is inimical to public health, safety, or welfare, and whether issuance of the license will undermine public trust that the gambling operations with respect to

which the license would be issued are free from criminal and dishonest elements and would be conducted honestly.

11. Business and Professions Code, section 19857 provides, in part:

> No gambling license shall be issued unless, based on all the information and documents submitted, the commission is satisfied that the applicant is all of the following:
>
> (a) A person of good character, honesty and integrity.
>
> (b) A person whose prior activities, criminal record, if any, reputation, habits, and associations do not pose a threat to the public interest of this state, or to the effective regulation and control of controlled gambling, or create or enhance the dangers of unsuitable, unfair, or illegal practices, methods, and activities in the conduct of controlled gambling or in the carrying on of the business and financial arrangements incidental thereto.

12. Business and Professions Code, section 19859 provides, in part:

> The commission shall deny a license to any applicant who is disqualified for any of the following reasons:
>
> (a) Failure of the applicant to clearly establish eligibility and qualification in accordance with this chapter.
>
> (b) Failure of the applicant to provide information, documentation, and assurances required by this chapter or requested by the chief, or failure of the applicant to reveal any fact material to qualification, or the supplying of information that is untrue or misleading as to a material fact pertaining to the qualification criteria.

13. Business and Professions Code, section 19866 provides:

> An applicant for licensing or for any approval or consent required by this chapter, shall make full and true disclosure of all information to the department and the commission as necessary to carry out the policies of this state relating to licensing, registration and control of gambling.

14. Business and Professions Code section 19876, subdivision (a) provides:

> Subject to the power of the commission to deny, revoke, suspend, condition, or limit any license, as provided in this chapter, a license shall be renewed biennially.

15. Business and Professions Code section 19920 provides:

> It is the policy of the State of California to require that all establishments wherein controlled gambling is conducted in this state be operated in a manner suitable to protect the public health, safety, and general welfare of the residents of the state. The responsibility for the employment and maintenance of suitable methods of operation rests with the owner licensee, and willful or persistent use or toleration of methods of operation deemed unsuitable by the commission or by local government shall constitute grounds for license revocation or other disciplinary action.

16. Business and Professions Code section 19922 provides:

> No owner licensee shall operate a gambling enterprise in violation of any provision of this chapter or any regulation adopted pursuant to this chapter.

17. Business and Professions Code section 19930, subdivisions (b), (d) and (f), provide in pertinent part:

> (b) If, after any investigation, the department is satisfied that a license, permit, finding of suitability, or approval should be suspended or revoked, it shall file an accusation with the commission in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.
>
> * * *
>
> (d) In any case in which the administrative law judge recommends that the commission . . . deny a license, the administrative law judge may, upon the presentation of suitable proof, order the licensee or applicant for a license to pay the department the reasonable costs of the investigation and prosecution of the case . . .
>
> * * *
>
> (f) For purposes of this section, "costs" include costs incurred for any of the following:
>
> (1) The investigation of the case by the department.
>
> (2) The preparation and prosecution of the case by the Office of the Attorney General.

18. Business and Professions Code section 19971 provides:

> This act is an exercise of the police powers of the state for the protection of the health, safety, and welfare of the people of the State

of California, and shall be liberally construed to effectuate those purposes.

19. Government Code, section 11504, provides, in part:

> A hearing to determine whether a right, authority, license, or privilege should be granted, issued, or renewed shall be initiated by filing a statement of issues. The statement of issues shall be a written statement specifying the statues and rules with which the respondent must show compliance by producing proof at the hearing, and in addition, any particular matters that have come to the initiating party and would authorize a denial of the agency sought action. . . .

20. California Code of Regulations, title 4, section 12035, subdivision (a)(1) provides:

> (a) The Commission shall issue an interim renewal license to an applicant for renewal of a license when:
>
> (1) The Commission has elected to hold an evidentiary hearing pursuant to paragraph (2) of subdivision (a) of Section 12054.

21. California Code of Regulations, title 4, section 12054, subdivision (a)(2) provides, in part:

> (a) At a non-evidentiary hearing meeting, the Commission may take, but is not limited to taking, one of the following actions:
>
> * * *
>
> (2) Elect to hold an evidentiary hearing in accordance with Section 12056 and, when for a renewal application, issue an interim renewal license pursuant to Section 12035. The Commission shall identify those issues for which it requires additional information or consideration related to the applicant's suitability.

22. California Code of Regulations, title 4, section 12056, subdivision (a) provides, in part:

> If the Commission elects to hold an evidentiary hearing, the hearing will be conducted as a GCA hearing under Section 12060, unless the Executive Director or the Commission determines the hearing should be conducted as an APA hearing under Section 12058 . . . .

23. California Code of Regulations, title 4, section 12058 provides:

> (a) When the Commission elects to hold an APA hearing the Commission shall determine whether the APA hearing will be held before

an Administrative Law Judge sitting on behalf of the Commission or before the Commission itself with an Administrative Law Judge presiding in accordance with Government Code section 11512. Notice of the APA hearing shall be provided to the applicant pursuant to Government Code section 11500 et seq.

(b) The burden of proof is on the applicant to prove his, her, or its qualifications to receive any license or other approval under the Act.

(c) A Statement of Issues shall be prepared and filed according to Government Code section 11504 by the complainant.

(d) At the conclusion of the evidentiary hearing, when the Commission is hearing the matter, the members of the Commission shall take the matter under submission, may discuss the matter in a closed session meeting, may leave the administrative record open in order to receive additional evidence as specified by the Commission, and may schedule future closed session meetings for deliberation.

(e) The evidentiary hearing shall proceed as indicated in the notice, unless and until the Executive Director or Commission approves cancellation or a continuance.

24. California Code of Regulations, title 4, section 12346, subdivision (a)(1) provides:

(a) An application for a gambling license shall be denied by the Commission if any of the following apply:

(1) The Commission finds that the applicant is ineligible, unqualified, disqualified, or unsuitable pursuant to the criteria set forth in the Act or other applicable law or that granting the license would be inimical to public health, safety, welfare, or would undermine the public trust that gambling operations are free from criminal or dishonest elements.

25. California Code of Regulations, title 4, section 12568, subdivision (c), provides, in part:

A state gambling license, finding of suitability, or approval granted by the Commission . . . and an owner license for a gambling establishment if the owner licensee has committed a separate violation from any violations committed by the gambling establishment shall be subject to revocation by the Commission on any of the following grounds:

* * *

(3) If the Commission finds the holder no longer meets any criterion for eligibility, qualification, suitability or continued

operation, including those set forth in Business and Professions Code section 19857, 19858, or 19880, as applicable, or

(4) If the Commission finds the holder currently meets any of the criteria for mandatory denial of an application set forth in Business and Professions Code sections 19859 or 19860.

APPENDIX B

POST-TRIAL DECISION AND ORDER
(NY SUPREME CT. CASE NO. 650049 (OCT. 21, 2014))

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART 49

----------X

CLUB ONE ACQUISITION CORP.,

Plaintiff,

-against-

GEORGE SARANTOS and ELAINE LONG,

Defendants.

----------X

KMGI, INC.,

Plaintiff-Intervenor.

----------X

POST-TRIAL DECISION AND ORDER

Index No.: 650049/2012

O. PETER SHERWOOD, J.:

This action arises from the sale of a gambling casino located in Fresno, California by Defendants, George Sarantos ("Sarantos") and Elaine Long ("Long") (together, "Defendants") to Plaintiff, Club One Acquisition Corp. ("Club One" or the "Company"). In this action, Club One seeks to block enforcement of judgments entered in the California Superior Court confirming an arbitration award for nearly $2 million against Club One and in favor of Defendants ("California Judgments"). Non-parties Dana Messina ("Messina") and Kyle Kirkland ("Kirkland") are 80% shareholders of Club One. Plaintiff-Intervenor, KMGI, Inc. ("KMGI") is a single purpose entity wholly owned by Kirkland and Messina and is the holder of Senior Notes secured by the casino. Club One seeks a declaration that a certain Subordination Agreement[1] entered into by Club One, its lender and Defendants prohibits Club One from paying amounts concededly owed Defendants pursuant to: (i) the California Judgments[2] and (ii) certain promissory notes issued by Club One in connection with Kirkland and Messina's acquisition of Club One Casino, Inc. ("Club One Casino") from the Defendants in February 2008 ("Seller Notes"), prior to payment in full of amounts owed

---

[1]The terms "Subordination Agreement," "Senior Indebtedness," "Purchase and Sale Agreement" and "Purchase Price Adjustment" are referenced in various documents used in connection with the sale of a gambling casino and are defined below at pages 4-6.

[2]The California Judgments represent a $1,000,513.00 post-closing purchase price adjustment owed to Defendants under the Purchase and Sale Agreement governing the acquisition of Club One Casino, plus legal fees, costs and interest awarded by the arbitrator.

under a loan obtained by Club One to finance the acquisition.[3] The Senior Notes are currently held by KMGI.

Defendants contend by way of affirmative defense that the provision of the Subordination Agreement relied on by Club One seeking to block payment of the California Judgments is unenforceable due to Club One's breach of the implied covenant of good faith and fair dealing. Defendants assert that rather than paying the post-closing Purchase Price Adjustment that they knew was legitimately owed, Club One, Kirkland and Messina (i) submitted a purchase price adjustment calculation that they knew was false and was designed solely to avoid payment of a legitimate obligation owed to Defendants; (ii) withheld payment of the correct Purchase Price Adjustment demanded by Defendants and forced Defendants through a protracted arbitration wherein Club One knowingly asserted frivolous counterclaims; (iii) engineered cash deficits and a default on Club One's Senior Indebtedness in order to invoke restrictions contained in the Subordination Agreement that is related to the Senior Indebtedness and thereby to avoid payment of the arbitration award; and (iv) secretly purchased the Senior Indebtedness and kept it in a perpetual state of default to avoid making any payments to Defendants.

In their Post-trial Brief Defendants request a judgment declaring that the Subordination Agreement does not bar payment of the California Judgments or amounts due pursuant to certain Seller Notes (*see* NYSCEF Doc. No. 166, p. 20). This request is the polar opposite of the relief requested by Club One and KMGI for a declaration that the Subordination Agreement bars Defendants from collecting on the California Judgments and an injunction against Defendants to the same effect (*see* NYSCEF Doc. Nos. 1 and 77).

In a Decision and Order dated September 30, 2013, this court denied Club One's motion for summary judgment seeking a declaration that (1) the Arbitration Award constitutes Subordinated Indebtedness under the Subordination Agreement; (2) the Subordination Agreement prohibits Defendants (the "Subordinated Creditors") from taking, demanding or receiving from Club One payment of any part of the Arbitration Award unless and until the Senior Indebtedness is paid in full;

---

[3]Club One and KMGI are represented by the same counsel. At trial they presented a single defense and submitted joint pre-trial and post-trial briefs. References in this Decision and Order to arguments made by Club One should be understood to be the arguments of both.

(3) the Subordination Agreement prohibits Club One from making, giving, or permitting any payment of any part of the Arbitration Award unless and until the Senior Indebtedness is paid in full; and (4) the Subordination Agreement prohibits the Defendants from exercising any of their rights or remedies with respect to the Arbitration Award unless and until the Senior Indebtedness is paid in full.

A non-jury trial was held on March 24-26, 2014 at which time the court heard evidence presented by all parties, and received extensive post-trial briefs. The case is now ready for decision on the merits.

FINDINGS OF FACT

The critical facts, which can be found in written contracts, related documents, and the findings in a decision accompanying an arbitration award involving Defendants and Club One, are largely undisputed. Club One accuses Defendants of attempting to re-litigate many of the issues already decided by the arbitrator, despite the fact that the arbitrator found in favor of Defendants. For its part, Club One states that it "does not dispute that the arbitrator ruled against it on those issues," but then proceeds to re-hash many of those rulings here. However, Club One's principal argument is that "the mere fact that [Club One] did not prevail at the arbitration does not mean that it acted in bad faith by defending itself in the arbitrations" (Club One Post-Trial Br. at 2). Much of the material proof offered at the trial was considered by the arbitrator. Generally, the findings of fact here are consistent with the findings of the arbitrator.

Club One Casino operates a licensed card room casino in Fresno, California (JX-42; Sarantos Trial Aff. 3). Club One Casino was founded by Sarantos and Charles "Bud" Long in 1995. In 2002, Long transferred his 50% interest in Club One Casino to his wife, Elaine Long. In July 2006, Sarantos, Elaine Long, Messina, and Kirkland signed a Letter of Intent ("LOI") providing that Kirkland and Messina would purchase Club One Casino from Sarantos and Long for $27 million (Tr. 46:12-19; JX-42 at 5).

Kirkland and Messina are "sophisticated and experienced businessmen" (JX-42 at 5). Before the parties signed the LOI, Kirkland and Messina had unrestricted opportunities to inspect the condition of Club One Casino, including its physical and financial condition. Sarantos provided

Kirkland and Messina with financial information, including tax returns and "compiled" financial statements for 2003, 2004, and 2005 (Tr. 48:4-11; 220:17-26; 221:12-26). Both Messina and Kirkland knew that the compiled financial statements were not audited (JX-42 at 12; Tr. 221:12-26; 70: 8-12).

After signing the LOI and for the next 19 months, due diligence continued through the closing which occurred on February 22, 2008 (Tr. 48:20-26). Messina and Kirkland were provided with information concerning Club One Casino's 2006 financial performance and had access to the card room casino (Tr. 48:15-24; 50:13-18). During this time, Kirkland and Messina also had full and unobstructed access to the company's books and records (JX-42 at 13; Tr. 52:5-14; *see also* Tr. 53:8-10). Kirkland and Messina also had their accountant, Ted Tawinganone, assist with due diligence prior to the closing (Tr. 56:3-19; 57:7-9). Around November of 2007, Baker Peterson was retained by Club One Casino, upon the recommendation of Kirkland and Messina, to perform an audit of Club One Casino for 2007 (JX-42 at 14). Kirkland and Messina were fully involved in the 2007 audit and communicated directly with the auditors on a regular basis prior to closing (Tr. 223:2-10, 15-23). As a result, Kirkland and Messina were aware prior to the closing that Club One Casino's 2007 financial statements would need to reduce the company's net income by approximately $750,000 in order to state the 2007 financials in accordance with Generally Accepted Accounting Principals ("GAAP") (Tr. 227). Additionally, in December 2006 or January 2007, the Defendants disclosed pending litigation against Club One, including the "Savang" litigation (JX-42 at 13; Tr.76-77).

On February 24, 2007, the parties executed an Agreement for Purchase and Sale of Stock ("PSA") (JX-2). Under the PSA, provision was made to adjust the purchase price after closing ("Purchase Price Adjustment") to address several factors, including the amount of cash retained by Club One Casino on the closing date (JX-2, § 3.5.1). The Purchase Price Adjustment Clause states as follows:

The Purchase Price shall be increased or decreased as follows:

(a) *increased* by the amount of Closing Date Cash;
(b) *decreased*, dollar-for-dollar, by the amount of the Balance Sheet Liabilities and any other amounts outstanding, whether consisting of principal, interest, penalty or other costs or expenses, under any indebtedness or similar obligations of the Company as of the Closing Date;

(c) *decreased* by three hundred ten thousand dollars ($3 1 0,000);
(d) *decreased* by 50% of the Fresno Tax Adjustment;
(e) *decreased* to the extent the Closing Date Balance Sheet does not conform to GAAP; and
(f) *increased* by the Section 338(h)(10) Adjustment Amount.

(JX-2, § 3.5.1; JX-42 at 8) (emphasis in original). The parties agreed that the Purchase Price Adjustment was to be calculated from the Closing Date Balance Sheet which Club One was required to prepare in accordance with GAAP and to provide to Defendants within 90 days of the Closing Date (JX-2, § 3.4).

Club One argues that Kirkland and Messina had "negotiated for and obtained strong seller representations and warranties" in the PSA (Club One Post-Trial Br. at 5). As to the dispute before the court, Club One adds that it "concluded, based on all of the undisclosed issues taken together and its strong contractural protections, that it had meritorious claim for breach of representations and warranties" (*id.*). Those representations and warranties, provided, *inter alia*, that, "[t]o the best knowledge of the Sellers and the Company, and *except as set forth on §4.3 of the Disclosure Statement* all financial statements delivered under this Agreement have been prepared in accordance with generally accepted accounting principles . . . " (JX-2, § 4.3) (emphasis added). Section 4.3 of the Disclosure Statement states that "compiled financial statements for the years ending December 31, 2003, 2004, and 2005," have been provided to the buyer[4] (Tr. 67:6-17). Thus, Kirkland and Messina had no reasonable expectation that these financial statements were prepared in accordance with GAAP (Tr. 220:17-26; 221:13-26; 48:4-14; 70:8-12) and were accurate (JX-42 at 18). The Disclosure Statement also attached a December 20, 2006 letter from Club One Casino's accountant describing deviations from GAAP (Tr. 67:6-17). In this litigation, Club One asserts that although it was aware of "certain deficiencies in the financial statements provided by Defendants," it "did not appreciate the full extent of this and other financial deficiencies until completion of the post-closing audit" (Club One Post-Trial Br. at 4). However, as the arbitrator found, Club One was fully aware that Defendants never represented that the 2004, 2005, and 2006 financial statements were prepared in accordance with GAAP (JX-42 at 12 and 18).

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[4]A financial statement for 2006 was also provided (*see* JX-42 at 12).

On February 22, 2008, the acquisition closed. It was highly leveraged. Club One financed the purchase with a $22.5 million loan ("Senior Loan") provided by D.B. Zwirn Special Opportunities Fund, L.P., later known as Fortress Value Recovery Fund I LLC ("Fortress" or "Lender"), pursuant to a Financing Agreement between Club One and the Lender, dated February 22, 2008 ("Financing Agreement") (JX-3) together with $5 million in Seller Notes held by Sarantos and Long. In addition, the sellers left in excess of 2.5 million in cash in Club One Casino's accounts to be paid to the Sellers after the adjustments were made pursuant to PSA §3.5.1 (Sarantos Aff. ¶ 13; Tr. 106:10-14). Kirkland states that he invested approximately $800,000 cash and together with Messina signed a $7 million joint and several personal guaranty ("Personal Guaranty") to secure the Senior Loan (JX-37; Kirkland Trial Aff. ¶ 18).

Prior to closing, Messina provided the Lender with a 2007 financial statement (DX-208), which had been prepared by Tawinganone at the direction of Kirkland and Messina (Tr. 225:16-22; 226:6-14). On February 22, 2008, the date of the closing, Messina signed a Compliance Certificate (DX-209) wherein he certified to the Lender that the 2007 financial statement attached to the certification (prepared by Tawinganone) "has been prepared in accordance with GAAP" and "fairly presents in all material respects the consolidated and consolidating financial condition of [Club One] and its Subsidiaries as of the date thereof or the consolidated and consolidating results of operations, retained earnings, and cash flows of [Club One] and its Subsidiaries for the period then ended" (DX-209; Tr. 231:3-10, 17-26; 232:2-233:3). Defendants maintain that this certification was false, as Messina had been advised by Baker Peterson, one day earlier, that the 2007 net income reflected in the existing financial statement for 2007 would have to be reduced by approximately $754,051 in order to state that the 2007 financials were prepared in accordance with GAAP (JX-42 at 16; Tr. 226:26-228:17, 234:3-23). Plaintiff responds that despite the discrepancy, the certification was "materially" accurate (Tr. 235:18-19). The purportedly "false" certification may not have been material to the Lender as the financial statement referred therein to was attached and states that it is "unaudited" (DX-209, at 4).

In connection with the Senior Loan, the Lender required Sarantos and Long to enter into a Seller Subordination Agreement ("Subordination Agreement"), dated February 22, 2008, whereby certain obligations owed them by Club One and Club One Casino would be subordinated to Club

One's obligations to the Lender (JX-40). Section 2(b)(2) of the Subordination Agreement provides generally that no Subordinated Indebtedness shall be paid to Defendants prior to payment of the Senior Indebtedness. The section contains a carve out which provides:

> [S]o long as (x) no Default or Event of Default shall have occurred and be continuing and (y) the Parent and its Subsidiaries shall have Qualified Cash[5] of not less than $500,000, in each case, both before and after giving effect to such payment, the Obligors may make and the Subordinated Creditors may accept (A) regularly scheduled payments of interest under the Subordinated Notes at a rate not to exceed 10% per annum (or such lesser rate as shall be the maximum rate allowable under applicable law) and (B) payments set forth in Section 3.5.1(a) and (f) of the [PSA] as and to the extent due and payable thereunder; and (ii) this Section 2(b)(2) shall not restrict the set off against or reduction in any amounts owing by the Obligors to the Subordinated Creditors under the Subordinated Notes against any indemnification or similar claims owing by the Subordinated Creditors to the Obligors under Section 11.1 of the [PSA].

(JX-40, § 2(b)(2)) (emphasis added). This provision expressly permits payment of interest on the Seller Notes and Club One's payment of the Purchase Price Adjustment pursuant to Sections 3.5.1(a) and (f) of the PSA, prior to payment in full of the Senior Indebtedness under certain circumstances (JX-40, § 2(b)(2); JX-2, § 3.5.1). Sarantos claims that based on the Purchase Price Adjustment provision and the language of the Subordination Agreement, he agreed to leave over $2,500,000 in cash in the business prior to closing in order to cover Defendants' prorated share of any debt that had been incurred prior to closing upon the understanding that any amounts belonging to him and Long would be returned post-closing as part of the PPA (Sarantos Trial Aff. ¶13).

By letter dated May 19, 2008, Club One provided the Closing Date Balance Sheet to Sarantos and Long (JX-56; JX-45; Tr. 200:23-25). Club One also provided schedules reflecting Club One's downward calculation of the Purchase Price Adjustment, which Club One claimed resulted in Defendants owing $23,051.27 to Club One (JX-56). The Purchase Price Adjustment calculation submitted by Club One is summarized in the following chart:

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[5]"'Qualified Cash' means, as of any date of determination, the amount of unrestricted cash and Cash Equivalents of the Parent and its Subsidiaries that is in deposit accounts or in securities accounts, or any combination thereof, and which such deposit account or securities account (I) is maintained by a branch office of the bank or securities intermediary located within the United States and (ii) is subject to the dominion and control of the agent" (JX-3 at 22).

Buyer's Purchase Price Adjustment Calculations		
Purchase Price (+/-)	**PSA Section Reference**	**Amount**
	§ 3.2 (Purchase Price)	$ 27,000,000
Increased	§ 3.4.1 (Closing Date Cash)	$2,338,733.85
Decreased	§ 3.4.2 (Balance Sheet Liabilities)	($ 1,364,716.03)
Decreased	§ 3.5.1 ($310,000)	($ 310,000)
Decreased	§ 3.4.2 (Fresno Tax Adjustment)	($ 666,500)
Decreased	§ 3.5.1 (Closing Date Bal. Sheet Not Conforming To GAAP)	($687,581.59)
Increased	§ 3.5.1 (338(h)(10) Adj.)	-
Total Price		**$26,309,936.23**[6]

(JX-56). Defendants rejected Club One's claim and demanded a PPA of $1,000,513 thereby creating a dispute, in Club One's view. Club One asserts that it made good faith efforts to resolve this dispute but that the arbitration ensued wherein it asserted a counterclaim for breach of representations and warranties contained in the PSA (Club One Post-Trial Br. at 5).

Defendants contend that Club One knew that its Purchase Price Adjustment calculation was not correct and contrary to Section 3.5.1 of the PSA. They assert that the PPA was submitted as part of an effort to try to reduce the amount it knew it would have to pay Defendants if the PPA was

[6]According to Club One, its Purchase Price Adjustment calculation resulted in a final purchase price of $26,309,936.23. It demanded $23,051.27 from the Defendants based on the amount paid at closing. This number was calculated by subtracting the $26,309,936.23 post-adjustment figure from the total amount the Club One paid at closing, $26,332,987.50 (JX-56).

calculated properly. Defendants point out that Messina admitted as much in an email to Vasan Kesavan of D.B. Zwirn,[7] on May 27, 2008. In that email Messina wrote:

> We are now going through the PPAs with the sellers. We are *being as aggressive as possible* with them and will hopefully save a few dollars. We have about $ 3 million in cash so *liquidity isn't an issue*. Originally *we expected to pay out $1.5 million in the PPA but are working hard to keep the number below $1 million.*

(JX-6) (emphasis added).

Defendants note also and the court agrees that Club One's May 19, 2008 calculation was not supported by any reasonable interpretation of the PSA. For example, Section 3.5.3 of the PSA provides that, "[t]he adjustment to the Purchase Price determined in accordance with clause (d) of Paragraph 3.5.1 [the Fresno Tax Adjustment] shall reduce the cash amount of the Purchase Price *payable at closing* to both Sellers" (JX-2, § 3.5.3) (emphasis added). Thus, the Fresno Tax Adjustment ($666,500) was accounted for *at closing* and was not meant to be asserted again as part of the *post-closing* Purchase Price Adjustment.[8] At trial, Messina admitted that Section 3.5.3 sets forth the timing of when payments calculated under Section 3.5.1 would be paid (Tr. 204:10-206:7).

Defendants maintain that Club One's assertion that the purchase price should have also been reduced by $687,581.59 to account for the Closing Date Balance Sheet not conforming to GAAP (JX-56) was equally unsupported by the language of the PSA, as well as the circumstances surrounding the transaction. The PSA provides for Club One to "cause the Company's accounting firm to review the Company's books and records as of the Closing Date . . . and to deliver, within 90 days following the Closing date, the balance sheet for the Company as of the Closing Date" (JX-2, § 3.4). Section 3.5.1 allowed a deduction only to the extent that the Closing Date Balance Sheet did not conform to GAAP (JX-2, § 3.5.1). Messina admitted at trial that the Closing Date Balance Sheet conforms to GAAP (Tr. 202:23-204:3).

Additionally Defendants argue that Club One's Purchase Price Adjustment calculation fails to properly account for Closing Date Cash, which is defined in section 3.4.1 as cash or cash

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[7]As of May 27, 2008 D.B. Zwirn was the Lender.

[8]The suggestion by Plaintiff's counsel that the PSA is ambiguous on this point (207:14-21) is meritless (*see* Tr. 207:7).

equivalents that "reasonably benefit the company" (JX-56; JX-2, § 3.4.1). Defendants note that Club One failed to include the chip liability account ($200,000) in its calculation of Closing Date Cash on the basis that the funds in the chip liability account did not reasonably benefit the Company[9] (JX-56, Tr. 198:23-199:5). As Defendants state, the claim that the chip liability account did not reasonably benefit the company is not supported by the plain definition of Closing Date Cash in the PSA (JX-2, § 3.4.1).[10] In fact, the chip liability account is cash that benefits the company, as it would provide an economic benefit to the stakeholders of the Casino were the company ever to dissolve (Tr. 199:18-200:4). The chip liability account was established by Sarantos shortly prior to closing to replace a letter of credit that had previously satisfied the chip liability requirement (Tr. 195:18-26; 197:3-7). As Messina admitted, the chip liability account allows the Company to stay in compliance with the regulatory regime governing casinos (Tr. 200:5-14). The parties always contemplated that the obligation to meet regulatory requirements concerning chip liability post-closing would be Club One's responsibility (Tr. 196:9-25).

By letter dated August 21, 2008, counsel for Defendants responded to Club One's May 19, 2008 letter, disputing Club One's assertion that a downward adjustment to the purchase price was warranted. The letter sets forth Defendants' calculation of the Purchase Price Adjustment. It shows an additional $1,000,513 owed to Defendants as is summarized in the following chart:

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[9]The company keeps cash in the cage reflecting the actual dollar value of casino gaming chips in circulation (Tr. 186:14-16). The chip liability account consists of funds held by Club One in order to comply with regulatory requirements and is in addition to funds owed to customers (Tr. 186:2-5).

[10]Notably, Baker Peterson originally did not classify the $200,000 chip liability account as restricted cash during his 2007 audit (Tr. 212:7-12). However, Messina made the decision to reclassify the chip liability account as restricted cash (Tr. 214:14-215:17). Messina knew that his position was contrary to the position taken by Defendants. In an April 23, 2012 e-mail to Baker Peterson concerning Marshall Scott's questioning of the potential reclassification of the chip liability account as restricted cash, Messina stated: "[i]f [Marshall Scott] wants to fight about the restricted cash he can do that in the arbitration process set up for the purchase price adjustment" (DX-207; Tr. 236:7-15).

Sellers Purchase Price Adjustment Calculation		
Purchase Price (+/-)	**PSA Section Reference**	**Amount**
	§ 3.2 (Purchase Price)	$ 27,000,000
Increased	§ 3.5.1(a) (Closing Date Cash)	$ 2,646,609
Decreased	§ 3.5.1(b) (Balance Sheet Liabilities)	($ 1,336,096)
Decreased	§ 3 .5.1(c) (Covenant)	$0
-	§ 3.5.1(d) and §3.5.3 (50% Fresno Tax Adjustment)	$0
-	§ 3.5.1(e) (Non-GAAP Adjustment)	$0
-	§ 3.5.1(f) (IRC § 338(h) Adjustment)	$0
Total Price		$ 28,000,513

(JX-7). The arbitrator concluded that this amount was correct (JX-42).

At the time the Purchase Price Adjustment became due, Club One had sufficient available cash to permit payment without violating the restrictions in the Subordination Agreement. On the day Defendants submitted their calculation of the Purchase Price Adjustment, no Default or Event of Default had occurred under the Financing Agreement and Club One would have had more than $500,000 in Qualified Cash on hand after paying the Purchase Price Adjustment demanded by Defendants (Tr. 97:12-14; 98:2-18; 100:16-25). As such, the Subordination Agreement was not a barrier to payment of the Purchase Price Adjustment in August 2008 when demanded by Defendants (Tr. 99:2-7) Nevertheless, Club One refused to pay the Purchase Price Adjustment (Sarantos Trial Aff. ¶28). Club One and KMGI now assert that the refusal may have been made in error but in bad faith.

Pursuant to Section 3.5.2 of the PSA, Sarantos and Long filed their respective demands for arbitration with the American Arbitration Association on December 30, 2008, each seeking a 50% portion of the $1,000,513 Purchase Price Adjustment. At that time, no Default or Event of Default

had occurred under the Financing Agreement and Club One would have had more than $500,000 in Qualified Cash after paying the Purchase Price Adjustment (JX-39 (December Financial Statement); Tr. 113:25-116:5).

In its January 8, 2009 response to Defendants' demands for arbitration, Club One asserted counterclaims alleging that Defendants had made misrepresentations, overstated net income, and hid Club One Casino's declining income and true financial condition by producing false financial statements, resulting in Club One having overpaid for Club One Casino by about $6 million (JX-42 at 3). Defendants argue that Club One asserted these counterclaims in a deliberate effort to prolong the arbitration and to delay paying the Purchase Price Adjustment.

Club One's counterclaims in the arbitration were without merit, as the arbitrator so held. As discussed above, prior to the closing Messina and Kirkland knew and at that time agreed that the financial statements provided to them were not prepared in accordance with GAAP (Tr: 70:8-12); (Tr. 221:20-222:5; JX-42, at 17). Messina and Kirkland were also given unfettered access to Club One Casino's facilities to inspect the property and were informed of all pending claims against the Casino, including the Savang litigation (Tr. 48:15-51:8; 76:10-10 77:10). Club One's claim that Sarantos misled it concerning the condition of Club One Casino's HVAC system, was equally unfounded. Kirkland conceded at trial that Sarantos never hid the condition of the HVAC system during the due diligence process (Tr. 119:7-9).

Moreover, as the arbitrator found, Club One's claim that it would not have closed the transaction had it known that the EBIDTA for 2007 was $5,884,864 (as opposed to $6,771,132) amounted to mere speculation (JX-42 at 19-21). The arbitrator held that even if such alleged financial inaccuracies were taken into account, Club One "received value in excess of what it had bargained for, not less" (JX-42 at 20).

Defendants assert correctly that even if Club One's counterclaims had merit, the PSA did not permit Club One to offset them against the Purchase Price Adjustment so as to withhold payment of the Purchase Price Adjustment (JX-2, § 11.1[a][iv]). Section 11.1 (a)(iv) provides that, "any indemnification claim . . . shall *be satisfied first by a set-off against or reduction in any amounts owed under the [Seller] Notes,* with such set-off or reduction applying to each note equally" (*id.*) (emphasis added). Club One's arbitration counterclaim amounted to between $3,531,162 and

$4,500,000 (JX-42 at 2 and 20), and therefore Club One had no right to set off its counterclaim beyond the value of the Seller Notes (Tr. 242:13-16 [Q: "[d]o you understand section 11.1 to allow the purchaser to a set off against monies due to the sellers pursuant to Section 3.5.1?" A [Messina]: "That's not my recollection."]).

Defendants argue that rather than paying the amounts legitimately owed to Defendants, Club One chose to ignore its obligations and intentionally dragged Defendants through a protracted, expensive and frivolous arbitration despite having Qualified Cash sufficient to pay the debt (JX-39). As proof of this claim, Defendants point out that between March 2008 and January 2012, Club One's Qualified Cash fluctuated between a low of $647,000 and a high of $2,607,550[11] (JX-39). In addition, Club One made significant pre-payments of principal to its Lender during 2008 and 2009 such that the amount of Qualified Cash would have been significantly higher had those pre-payments not been made.[12] Defendants assert that Club One was making pre-payments to its Lender in an attempt to keep its Qualified Cash balance artificially low. As further proof, Defendants cite a December 11, 2009 email to Lender, in which Messina stated in relevant part, "[w]e wanted to request your approval to pay down the the loan by $750,000 on December 15 and credit the amount against upcoming payments due early next year . . . *We believe it is important to reduce the amount of cash on our year-end balance sheet as we head into the arbitration proceedings"* (PX-107) (emphasis added). On the basis of this and other evidence discussed below and the court's assessment of the credibility of Kirkland and Messina at trial, the finds that Kirkland and Messina, fully expecting to lose the arbitration, intentionally reduced the amount of Qualified Cash on hand

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[11]Even if it was unable to pay the full Purchase Price Adjustment in a single month, it had the ability to pay a portion of the Purchase Price Adjustment every month without falling below the $500,000 minimum Qualified Cash threshold.

[12]In a September 17, 2008 email to Lender, Messina stated in relevant part, "We presently have a significant sum sitting with our local Fresno bank . . . we would like to pay down a total of $750,000 of the principal . . ." (JX-9). In an October 26, 2009 email to Lender, Messina stated in relevant part, "[t]he balance sheet remains in good shape. We ended the month with $2 million in cash . . . and made an accelerated principal payment on our loan of $500,000, bringing the outstanding balance to $19.4 million" (JX-11;Tr. 275:18-23 [Q: "[t]hen you in fact made that payment, that prepayment of $750,000 in December of 2008 [sic], correct?" A [Messina]: "It was a similar payment to the one we made the year before . . ."]).

at Club One Casino in order to enable Club One to assert after losing the arbitration that the Subordination Agreement prohibited payment of the Purchase Price Adjustment.

In an Interim Award dated April 12, 2011, the arbitrator concluded that Club One's counterclaims were entirely without merit, and that Defendants' calculation of the Purchase Price Adjustment was correct, such that Sarantos and Long were each entitled to receive 50% of $1,000,513.00 (JX-42 at 17 and 25). The arbitrator also noted that Club One had Ted Tawinganone prepare a "re-engineered" version of the 2007 financial statements of Club One Casino, which Club One sent to its Lender about one month before the closing of the acquisition in order to secure the $22.5 million loan used to purchase Club One (*id.* at 15 and 17).[13] Additionally, the arbitrator, who observed Kirkland and Messina throughout the hearings, questioned their credibility (*id.* at 17). The arbitrator stated:

> The claims of Respondent Buyer's representatives [Kirkland and Messina] to the contrary, i.e., that they did not know or understand or could not have known this, are simply not credible in light of this evidence. The credibility of their assertions is also brought into question for the reasons stated in Claimants' post-hearing briefs, i.e., evasive and inconsistent testimony under oath in the hearings, grossly inaccurate and misleading statements made under oath in a pre-hearing declaration submitted in this arbitration, and questionable conduct in submitting a reengineered financial statement to Respondent Buyer's lender.

(*id.*). Of particular relevance to the issue before this court, the arbitrator observed in a subsequent Interim Award that:

> The record shows that the disputes or disagreements between the parties that led to the present arbitration (and that Respondent used to justify withholding payment of the $1,000,513) were not about whether "any adjustments to the Purchase Price are permitted pursuant to Paragraph 3.5.1, "but rather were the result of Respondent asserting a counterclaim accusing Claimants of fraudulent misrepresentation based upon which Respondent demanded a reduction of the price they had paid for the Casino. Respondent did not dispute the accuracy of the Closing Day Balance Sheet ["CDBS"]. Nor did respondent's arbitration counter-demand dated January 5, 2009 and submitted to American Arbitration Association ("Association") on January 8, 2009 assert that there were "any disagreements for which adjustments to the Purchase Price are permitted pursuant to [Section 3.5.1]".

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[13]As discussed above, Club One knew that these financial statements were incorrect, but certified them and forwarded them to the Lender anyway (Tr. 231:3-10;225:16-22; 226:26-228:17; 234:3-23).

> Rather, it alleged that "[Claimants] made misrepresentations, overstated net income and hid the casino's declining income and true financial condition by producing false and fraudulent financial statements. As a result, Buyer paid much more for the casino than it was worth. Consequently, it is Claimant's position that the purchase price needs to be adjusted downward." The counter-demand essentially sought an "offset" against the $1,000,513 upward price adjustment reflected by the CDBS. Although issues were eventually raised by Respondent later in the arbitration process regarding certain line items in the CDBS such as "restricted cash" and "chip liability", they arose in the context of alleged misrepresentations or non-disclosures by Claimants, rather than under any of the scenarios listed in the aforementioned subsections of Section 3.5.1. (JX-16, p. 3).

(*id.*). Finding that pursuant to § 3.5.3 of the PSA, Club One became obligated to pay Defendants $1,000,513, the arbitrator awarded interest from April 10, 2008, which is the date the exact amount of the PPA became known and should have been paid.

Upon issuance of the first Interim Award in April 2011, Club One, Messina and Kirkland set out on a course of action intended to prevent Defendants from reaping the fruits of the arbitrator's decision. In an email to Fortress (the "Lender") sent immediately following issuance of the award, Messina wrote, "[w]e have received notification that we lost the arbitration case . . . . We are obviously disappointed by the outcome and are developing a strategy to address this. In the next week, we will contact you with our ideas and to solicit your input. Please note that *we remain in good financial health despite this setback and are current with all our obligations*" (JX-12) (emphasis added). The strategy Club One developed called for Fortress to send a letter (drafted by counsel for Club One) instructing Club One not to pay any award to Defendants on the theory that payment of the Arbitration Award was prohibited by terms of the Subordination Agreement (JX-13; Tr. 282:2-284:7). Fortress consented and worked with Messina and Kirkland on drafts of the letter which it then sent to Club One, Sarantos and Long on July 13, 2011. Fortress came to rue its participation in Club One's battle to avoid paying the debt owed Defendants (PX-145).

DISCUSSION

Plaintiffs state correctly that this case turns on one narrow issue: Whether Club One breached the implied covenant of good faith and fair dealing. This issue is distinct from that decided by the arbitrator.

It is well settled that within every contract is an implied covenant of good faith and fair dealings (*see 511 West 232nd Owners Corp. v Jennifer Realty Co.*, 98 NY 2d 144, 153 [2002]; *Dalton v Educational Testing Service,* 87 NY 2d 384, 389 [1995]). The implied covenant "embraces a pledge that neither party shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (*511 West 232nd Owners Corp.*, 98 NY 2d at 153 [internal quotation marks omitted]; *see also 6243 Jericho Realty Corp. v AutoZone, Inc.*, 71 AD 3d 983, 984 [2d Dept 2010]; and *Moran v Erk*, 11 NY 3d 452, 457 [2008]). A breach of the covenant is a breach of the contract itself (*see Boscoral Operating, LLC v Nautica Apparel, Inc.*, 298 AD 2d 330, 331 [1st Dept 2002]). The covenant of good faith and fair dealing is breached when a party acts in a manner that, although not expressly forbidden by the contractual provision, would deprive the other party of the benefits of the agreement (*see 511 West 232nd Owners Corp.*, 98 NY 2d at 153; *Sorenson v Bridge Capital Corp.*, 52 AD 3d 265, 267 [1st Dept 2008]).

The covenant encompasses any promises that a reasonable person in the position of the promisee would be justified in understanding were included (*see 511 West 232nd Owners Corp.*, 98 NY 2d at 153; *Ochal v Television Technology Corp.*, 26 AD 3d 575, 576 [3d Dept 2006]). However, the obligations imposed by an implied covenant of good faith and fair dealing are limited to obligations in aid and furtherance of the explicit terms of the parties' agreement (*see Trump on Ocean, LLC v State,* 79 AD 3d 1325, 1326 [3d Dept 2010]). The covenant cannot be construed so broadly as to nullify the express terms of a contract, or to create independent contractual rights (*see Phoenix Capital Investments LLC v Ellington management Group, L.L.C.,* 51 AD 3d 549, 550 [1st Dept 2008]; *767 Third Ave. LLC v Greble & Finger, LLP,* 8 AD 3d 75, [1st Dept 2004]; *SNS Bank, N.V. v Citibank, N.A.,* 7 AD 3d 352, 355 [1st Dept 2004]; *Fesseha v TD Waterhouse Investor Services, Inc.*, 305 AD 2d 268, [1st Dept 2003]). To establish a breach of the implied covenant, the Plaintiff must allege facts that tend to show that the Defendants sought to prevent performance of the contract or to withhold its benefits from the Plaintiff (*see Aventine Investment Mgmt., Inc., v Canadian Imperial Bank of Communications Inc.,* 222 AD 2d 17, 22 [1st Dept 1996]).

Defendants pleaded the implied covenant of good faith and fair dealing claim as an affirmative defense (*see* NYSCEF Doc. Nos. 43, ¶ 52 and 79, ¶ 60). Accordingly, Defendants had the burden of proving, by a preponderance of evidence, that Club One breached the implied covenant

(*see Haymarket LLC v. D.G. Jewellery of Can.*, 290 AD 2d 318 [1st Dept 2002] [breach of implied covenant of good faith and fair dealing is affirmative defense]; *Structure Tone, Inc. v UniversalServs. Grp.*, 87 AD 3d 909, 910 [1st Dept 2011] [same]; *Manion v Pan Am. WorldAirways, Inc.*, 55 NY2d 398, 405 [1982] [party asserting affirmative defense bears burden of proof]; *Cohen v Akabas & Cohen,* 79 AD 3d 460, 462 [1st Dept 2010] [must prove affirmative defenses by preponderance of evidence]).

"'Good faith' means honesty in fact in the conduct or transaction" (NYUCC § 1-201 [19]). According to the Restatement 2d of Contracts, § 205, good faith performance of a contract "emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other part". While the phrase excludes the types of conduct characterized as involving "bad faith", violation of the covenant of good faith and fair dealing is not restricted to bad faith conduct. Subterfuges and evasions violate the obligation of good faith in performance of a contract even though the actor believes his conduct to be justified (*see id.*).

A breach of the implied covenant of good faith and fair dealing requires evidence that a party "sought to prevent performance of the contract or to withhold its benefits" (*Aventine Inv.*, 232 AD 2d at 514). A party does not breach the implied covenant of good faith and fair dealing when it acts within its express contractual rights (*see Natl. Union Fire Ins. Co. v Xerox Corp.*, 25 AD 3d 309, 310 [1st Dept 2006]). Thus, where a party "d[oes] precisely what the contract permitted, any question of bad faith ... is irrelevant" (*Maxon Int'l v Int'l Harvester Co.*, 82 AD2d 1006, 1007 [3d Dept 1981]).

While acknowledging that the arbitrator ultimately ruled in favor of Defendants with respect to the PPA and Club One's counterclaims, Club One argues correctly that the mere fact that it lost the arbitration does not mean that it acted in bad faith (*see Fairchild Corp. v Alcoa, Inc.*, 510 F Supp 2d 280, 298 [SD NY 2007] ["[L]osing arguments, even if decidedly tenuous, are not necessarily frivolous, or equate to evidence of bad faith"]). Club One asserts that the evidence demonstrating its reasonable belief in the merits of its PPA defenses and its counterclaims supports the conclusion that it acted in good faith in asserting them. Club One adds that while it strongly disagrees with the arbitrator's decision and commentary therein, the arbitrator's criticisms of Messrs. Kirkland and Messina are not entitled to res judicata or collateral estoppel effect on the issue of bad faith in this

case. It argues that res judicata and collateral estoppel apply only if "the issue in the prior proceeding was actually litigated and decided" (*see Gersten v 56 7th Ave. LLC*, 88 AD3d 189, 202 [1st Dept 2011]; *see also Theodore v TD Ameritrade*, 18 Misc 3d 1134[A], 859 NYS2d 899 [Sup Ct Nassau Ctny Feb. 11, 2008]; *Lepercq Defeuflize & Co. v Helmsley*, 198 AD2d 147 [1st Dept 1993]). Neither doctrine is being applied here to preclude receipt of evidence as to the actions of either Messina or Kirkland. The findings of the arbitrator are being treated as evidence to be weighed as appropriate along with all of the other proof introduced in evidence at trial.

Defendants contend that Club One breached the implied covenant of good faith and fair dealing by: (i) refusing to pay the Purchase Price Adjustment when it became due, even though the Subordination Agreement permitted payment; (ii) submitting a Purchase Price Adjustment calculation that it knew was incorrect and contrary to the plain language of the PSA and was designed solely to avoid payment of a legitimate obligation owed to Defendants; (iii) continuing to withhold payment of the Purchase Price Adjustment throughout the arbitration process and asserting frivolous counterclaims that Plaintiff knew had no basis in fact; (iv) engineering cash deficits and a default on the Senior Loan to void payment of the arbitration award; and (v) secretly purchasing the Senior Loan and intentionally keeping it in a perpetual state of default to avoid making any payments to the Sellers. Some of these contentions have merit in that they illustrate deliberate actions Club One took to avoid or delay making payment of the Purchase Price Adjustment at times when payment could and should have been paid without objection by the Lender. By so doing, Club One injured Defendants' right to receive the fruits of the PSA.

Club One argues that the mere fact that it did not prevail in the arbitration "does not mean that it acted in bad faith by defending itself in the arbitration" (Club One Post-Trial Br. at 2). It maintains that (1) it acted within its express contractual rights; (2) it had a good faith basis for disputing the PPA and asserting counterclaims in the arbitration; (3) it acted in good faith in pre-paying the Senior Loan; (4) it did not "manufacture" a maturity default; and (5) its principals reasonably concluded that the KMGI purchase of the Senior Loan was the best available options for all stakeholders. Although it has a right to defend itself in an arbitration, Club One may not insist on arbitration or continue an arbitration when, as occurred here, its defense was utterly meritless and procedurally untenable.

At trial Defendants proved that allowable adjustments to the Purchase Price are limited to those items listed in §3.5.1 of the PPA. The adjustments permitted to be made were calculated to be $1,000,513. Club One elected not to pay this amount when it became due even though it was able to do so without violating any of the covenants of the Senior Loan. Instead it sought to "set-off" the amount owed by asserting violations of "strong seller representations and warranties in the [PSA]" (Club One Post-Trial Br. at 5). The arbitrator rejected these assertions and held that "Long and Sarantos did not knowingly engage in any intentional or negligent misrepresentation or non-disclosures of any material facts that would be actionable . . . as a material breach of the terms on the PSA" (JX-42, p. 17).

As described above, §3.5.1 of the PSA sets forth a list of all of the allowable adjustments to the Purchase Price. The "set-offs" which Club One claimed in the arbitration (and at trial) appear nowhere on that list. Further, there was no basis for making a downward Purchase Price Adjustment on account of Fresno taxes because those taxes were expressly accounted for at the closing (*see* JX-02, §3.5.3 first sentence). Kirkland's attempt at trial to justify making an adjustment to the PPA for such taxes was disingenuous (Tr. 205-206). Similarly, there were no grounds for making a downward adjustment pursuant to PSA §3.5.1(e) ("decrease [] to the extent the Closing Date Balance Sheet does not conform to GAAP") because the Closing Date Balance Sheet did conform to GAAP (Tr. 201).

In the arbitration, Club One's defense did not focus on whether the adjustments were proper, but instead on its counterclaim which alleged "damages caused by the misrepresentations and inaccuracies in the Seller's financial statements provided to buyers prior to closing" (JX-42 at 2 quoting from Club One's Supplemental Br. Re: Damages). However, Club One was not authorized to "set-off" the amount owed to Sarantos and Long pursuant to PSA §3.5.3 as an adjustment to the Purchase Price (*see* JX-42, §3.5.3).

The counterclaim was largely bogus as the arbitration award reveals. In this regard the court notes the following passage in the arbitration award:

> The record shows that the disputes or disagreements between the parties that led to the present arbitration (and that Respondent used to justify withholding payment of the $1,000,513) were not about whether any adjustments to the Purchase Price are permitted pursuant to "Paragraph 3.5.1," but rather were the result of Respondent

> asserting a counterclaim accusing Claimants of fraudulent misrepresentation based upon which Respondent demanded a reduction of the price they had paid for [COC]. Respondent did not dispute the accuracy of the CDBS. Nor did Respondent's arbitration counter-demand dated January 5, 2009 and submitted to American Arbitration Association ("Association") on January 8, 2009 assert that there were "any disagreements for which adjustments to the Purchase Price are permitted pursuant to "[Section 3.5.1]". Rather, it alleged that "[Claimants] made misrepresentations, overstated net income and hid [COC]'s declining income and true financial condition by producing false and fraudulent financial statements. As a result, Buyer paid much more for [COC] than it was worth. Consequently, it is Claimant's position that the purchase price needs to be adjusted downward." The counter-demand essentially sought an "offset" against the $1,000,513 upward price adjustment reflected by the CDBS. Although issues were eventually raised by Respondent later in the arbitration process regarding certain line items in the CDBS such as "restricted cash" and "chip liability", they arose in the context of alleged misrepresentations or non-disclosures by Claimants, rather than under any of the scenarios listed in the aforementioned subsections of Section 3.5.1.
>
> * * *
>
> *But for Respondent's assertion of its fraud claims, the matter should have been resolved shortly after closing without the need for the legal interplay that ensued thereafter on the way to a likely and eventual arbitration.*

(JX-16 at pp.3-4) (emphasis added). Thus, Club One's effort to minimize the impact of the arbitrator's award by characterizing the ruling as being based "largely on legal arguments" (Club One Post-Trial Br., p. 12) is rejected.

In his affidavit presented at trial and in an attempt to justify the breach of warranties defense, Kirkland states misleadingly that "the Defendants represented in the [PSA] that (a) [t]he financial statements the provided to me and Mr. Messina were 'prepared in accordance with generally accepted accounting principles' and 'true, complete and correct in all material respects in accordance with the books and records of the Company.' See JX-002 §4.3". In fact, the introductory clause to the sentence from which the quoted language was extracted shows that was not the understanding of the parties. The clause provides "[t]o the best knowledge of the Sellers and the Company, *except as set forth in Part 4.3 of the Disclosure Statement . . .*" (*id.*) (emphasis added). Section 4.3 also states that "Part 4.3 of the Disclosure Statement sets forth the *compiled* financial statements of the Company . . ."(*id.*) (emphasis added). Thus, the parties agreed that the financial statements provided

for the relevant years - - 2003 through 2006 - - were *not* prepared in accordance with GAAP. To the extent the counterclaim in arbitration asserted otherwise, it was baseless.[14]

Under the terms of the PSA, Defendants had an expectation that sums withheld from the Purchase Price at the closing would be paid once the purchase price adjustments contemplated by the parties were made. The Purchase Price Adjustment provision was not intended as a vehicle for re-negotiation of the purchase price. The Subordination Agreement reflects the parties' bargained for agreement that the Purchase Price Adjustment would be paid only if Club One was not in financial distress. As of April 2008 and as of the time the demand for arbitration was made in December 2008, Club One was not in financial distress and could have paid the Purchase Price Adjustment. Instead Club One elected to "set-off" its payment obligations by asserting a meritless counterclaim in violation of its implied pledge not to "do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" *(511 West 232nd Owners Corp.,* 98 NY 2d at 153). As the arbitrator held: "[b]ut for Respondent's assertion of its fraud claim, the matter should have been resolved shortly after closing without the need for the legal interplay that ensued thereafter on the way to a likely and eventual arbitration" (JX-16 at 4).

Even assuming that Club One had valid representation and warranty claims against Defendants under the terms of the PSA, such claims were to be set-off against amounts owed Sarantos and Long under the terms of the Seller Notes (JX-2, §§ 3.5.3 and 11.1 [a][iv]). Instead, Club One elected to be "as aggressive as possible" (JX-6) and to breach of its contractual obligations. Through a series of subterfuges and evasions, Club One and its principals have succeeded in evading payment properly owed to Defendants as of April 2008.

After it became evident that Club One would not prevail in the arbitration, Messina and Kirkland charted a course of conduct designed to shield themselves from having to pay. Their acts of evasion and obfuscation included (1) pre-payment of principal on the Senior Loan in order to reduce the amount of cash available to Club One to pay an expected adverse arbitration award (*see* PX-107); (2) successful lobbying of Fortress issue a notice designed to shield Club One from having

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[14]As discussed above, Messina and Kirkland had detailed knowledge of the financial records of the Seller prior to the closing and were well aware that the financial statements for 2003-2006 were not GAAP compliant.

to pay the arbitration award (JX-12, 13, 14; Tr. 280-284, 286); and (3) failure of Kirkland and Messina to take reasonable measures to avoid a maturity default on February 23, 2012 followed by their purchase of the Senior Loan and paying themselves "default interest" on the Senior Loan (Saranto Aff. ¶55).

In response to the initial urging of Kirkland and Messina in April 2011, Fortress expressed interest in either having the award paid by Messina and Kirkland out of their funds of or by payment of a compromise amount paid out of Club One funds (JX-12; Tr. 283-285). As a part of its lobbying efforts, Club One directed its attorneys to draft a subordination notice which Fortress would send to Club One and Defendants.[15] The draft notice was sent to Fortress on April 25, 2011 but Fortress did nothing with it until after June 28, 2011 when, following issuance on June 27, 2011 of an Interim Order awarding interest and attorney fees, Messina urged it to act (JX-14). At that time, Messina advised Fortress that "it is now imperative that our lenders issue a notice to us and enforcing the language in our agreement" (*id.*). Messina also re-offered the draft notice. After a series of re-drafts (JX-17, 18), Fortress issued the notice on July 13, 2011. The notice purported to bar not only payment of the arbitration award but also directed cessation of all interest payments on the Subordinated Notes (JX 17 at p. FORT0000823 ["under the terms of the Subordination Agreement, since one or more defaults have occurred and are continuing no Subordinated Indebtedness whatsoever may be paid, *including interest payments* under the Subordinated Notes"]) (emphasis added).[16] On July 19, 2011, Kirkland "confirmed" to Fortress that Club One would "comply with [Fortress'] demands . . . that it discontinue payments of interest on the Subordinated Notes" (Kirkland Aff. ¶57). Thereafter, Club One refused to make further interest payments on the Seller

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[15]Kirkland testified that the notice was prepared "[a]t the lenders' request" (Tr. 282). This testimony was false (Benjamin Deposition pp. 44, 46; Tr. 286; PX-145 ["Club One: Lessoned [sic] Learned: Stay out of someone else's battle. Club One our borrower asked us to write a letter prevent [sic] payments to subordinate debt. This was not Fortress battle to fight . . ."]).

[16]There were number of defaults unrelated to the arbitration prior to July 13, 2011. Despite the existence of such events of default, Fortress did not seek to bar Club One from continuing to make interest payments on the Subordinated Notes until after it joined Messina and Kirkland's "battle" with Sarantos and Long (JX-115; Kirkland Aff. ¶ ¶ 51, 54).

Notes (Saranto Affd. ¶43). Club One's actions, taken in bad faith, had the foreseeable effect of increasing Club One's leverage in attempting to avoid its payment obligations under the arbitration award.

Having considered all of the evidence submitted at the trial and having observed the witnesses, the court finds that Plaintiff, Club One and its principals breached the covenant of good faith and fair dealing owed to Defendants. Club One breached its obligation to make payment to Defendants under the terms of the Purchase Price Adjustment provision of the PSA. Club One pursued the arbitration in bad faith, specifically in its pursuit of a meritless and procedurally flawed counterclaim. Kirkland and Messina, who directed the initial breach in 2008, enlisted Fortress in 2011 to issue a notice not to pay the arbitration award and to cease making interest payments to Sarantos and Long. These actions were taken in bad faith.

On February 23, 2012 the Senior Loan matured. At that point Kirkland and Messina were presented with options. They could have (1) paid the loan and expose Club One to the California Judgment; (2) refinanced the loan and negotiated regarding payment of the arbitration award; or (3) bought the defaulted loan and thereby continue to frustrate Defendants' efforts to be paid. Kirkland and Messina elected the last, thereby (a) further styming payment of the arbitration award; (b) continuing to avoid payment of interest due under the terms of the Subordinated Notes; and (c) accruing for themselves "default" interest at an annual rate of 16.5%. Having acquired the Senior Loan, Messina and Kirkland directed KMGI to release the Personal Guaranty which they had given to the Lender at the time the Senior Loan was made.

Club One and KMGI maintain that "this case is just about timing" (Plaintiff's Post-Trial Br. at 1). Club One's actions in violation of the implied covenant of good faith and fair dealing has re-ordered the expectations of the parties as to the timing of certain payments due Defendants. In August 2008, Messina and Kirkland through Club One refused to return money owed to Sarantos and Long without good reason. Through abuse of the terms of the Subordination Agreement in ways never intended by the parties at the time of execution, Messina and Kirkland successfully deferred payment of the Purchase Price Adjustment for over six (6) years and re-ordered the timing of interest payments on the Seller Notes. The Senior Loan of which the Subordination Agreement is a part, matured in February 2012. Fortress, the Lender at that time, has been paid out of funds provided by

Messina and Kirkland. Each Personal Guaranty given by Messina and Kirkland to the Lender in connection with the Senior Loan has been released. The Seller Notes (held by Sarantos and Long) have matured but the loans remain unpaid. Interest on the Seller Notes continue to be suspended at the behest of Messina and Kirkland. Although the matured Senior Loan is in default, Messina and Kirkland have chosen not to foreclose on it. Instead they have elected to hold the Senior Loan and to accrue default interest. Whether and when Long and Sarantos will be able to enforce their rights to payment against Club One rests entirely in the hands of Messina and Kirkland. In effect, Sarantos and Long are the only parties involved in the sale of Club One Casino who are still awaiting payment. Their inability to get paid before now is a result of the bad faith actions of Club One and its principals.

Club One violated the covenant of good faith and fair dealing in connection with the PPA. Defendants are entitled to a declaration that the Subordination Agreement now controlled by Messina and Kirkland does not bar payment of the California Judgments by Club One. In 2011 Fortress had the contractual right to bar payment of the arbitration award but its ability to exercise that right was the product of bad faith conduct of Club One, Messina and Kirkland years earlier.

At the time of the closing in 2008, all parties, including the Lender, expected that as a result of the purchase price adjustment provision of the PSA, Defendants' contractual right to payment of the portion of the purchase price that had been withheld would be honored within a few months. With knowledge of Club One's breach of its contractual obligation to pay the PPA, the Lender joined in the efforts of Messina and Kirkland on behalf of Club One to frustrate enforcement of rights that had accrued in 2008 at which time the Subordination Agreement did not present a bar to payment. The court will not countenance the efforts of Messina and Kirkland (who now own the Senior Loan) and the Lender to enable Club One's avoidance of its long overdue payment obligation. Given the economic realities presented in this case where Messina and Kirkland who control both the judgement debtor (1) orchestrated the breach of the PSA; (2) enlisted the Lender's aid to shield themselves; and (3) are now directing the joint effort of Club One and KMGI to further delay payment, KMGI's request for a declaration that neither the Arbitration Award nor the California Judgements may be paid by Club One until the Senior Loan has been paid in full must be denied.

Although procured at the urging of Messina and Kirkland, Fortress had the contractual right to direct cessation of interest payments on the Seller Notes and to declare a maturity default of the Senior Loan even if Club One had not breached the PPA. The covenant of good faith and fair dealing cannot be extended to nullify the rights of Fortress as the Lender to direct cessation of interest payments in July 2011 and to declare a maturity default in 2012. The request of Defendants for a declaration relating to Club One's ability to meet its obligations under the terms of the Seller Notes must be denied given the restrictions imposed on it under the terms of the Subordination Agreement.

Accordingly, it is hereby

ADJUDGED and ORDERED that the complaint of Plaintiff, Club One Acquisition Corp., is DISMISSED; and it is further

ORDERED and ADJUDGED that upon the intervenor amended complaint (NYSCEF Doc. No. 77) of KMGI, Inc., it is hereby declared that no payment of interest or other payments of the Subordinated Notes may be paid by Club One prior to payment in full of the Senior Indebtedness; and it is further

ADJUDGED and ORDERED that upon Defendants' affirmative defenses it is hereby declared that the Subordination Agreement does not bar payment of either the Arbitration Award or the California Judgments confirming the Arbitration Award prior to payment in full of the Senior Indebtedness; and it is further

ORDERED that having prevailed in this action against Plaintiff, Club One, and Plaintiff-Intervenor, KMGI, Inc., that portion of the action that seeks the recovery of attorney's fees and costs is severed and the issue of the amount of reasonable attorney's fees Defendants, George Sarantos and Elaine Long, may recover against the Plaintiff, Club One Acquisition Corp., (JX-2, p. 7) is referred to a Special Referee to hear and report; and it is further

ORDERED that counsel for the Defendants shall, within fourteen (14) days from the date of this order, serve a copy of this order with notice of entry, together with a completed Information

Sheet[17], upon the Special Referee Clerk in the Motion Support Office (Room 119M), who is directed to place this matter on the calendar of the Special Referee's Part for the earliest convenient date.

This constitutes the decision and order of the court.

DATED: October 21, 2014

E N T E R,

O. PETER SHERWOOD
J.S.C.

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[17]Copies are available in Room 119M at 60 Centre Street and on the Court's website at www.nycourts.gove/supcmanh under the "References" section of the "Courthouse Procedures" link).

APPENDIX C

ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDING, MAKING FINDINGS AND IMPOSING SANCTIONS AND CEASE-AND-DESIST ORDER

(SECURITIES AND EXCHANGE COMMISSION FILE NO. 3-10602 (SEP. 28, 2001))

U.S. Securities and Exchange Commission

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8019 / September 28, 2001

SECURITIES EXCHANGE ACT OF 1934
Release No. 44876 / September 28, 2001

INVESTMENT ADVISERS ACT OF 1940
Release No. 1982 / September 28, 2001

INVESTMENT COMPANY ACT OF 1940
Release No. 25199 / September 28, 2001

ADMINISTRATIVE PROCEEDING
File No. 3-10602

In the Matter of KYLE R. KIRKLAND, Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDING, MAKING FINDINGS AND IMPOSING SANCTIONS AND CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate in the public interest to institute a public administrative and cease-and-desist proceeding pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and (f) of the Investment Company Act of 1940 ("Investment Company Act") against Respondent Kyle R. Kirkland ("Kirkland" or "Respondent").

II.

In anticipation of the institution of this administrative proceeding, Kirkland has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings contained herein, except that Kirkland admits the jurisdiction of the Commission over him and over the subject matter of this proceeding, Kirkland consents to the entry of this Order Instituting Public Administrative

And Cease-And-Desist Proceeding, Making Findings and Imposing Sanctions and Cease-and-Desist Order ("Order").

Accordingly, IT IS HEREBY ORDERED that a proceeding pursuant to Section 8A of the Securities Act, Sections 15(b)(6) and 21C of the Exchange Act, Section 203(k) of the Advisers Act and Sections 9(b) and (f) of the Investment Company Act be, and hereby is, instituted.

III.

On the basis of this Order and Kirkland's Offer, the Commission finds that:

A. SUMMARY

This matter involves a portfolio manager and Kirkland, a principal of a former broker-dealer who engaged in acts that resulted in the overstatement of the net asset value ("NAV") of a mutual fund and an offshore fund from 1996 to 1998. The portfolio manager caused the funds to purchase securities underwritten by the broker-dealer and Kirkland. After the securities began performing poorly and the issuers suffered severe financial problems, Kirkland provided information as to the value of certain securities without disclosing that the valuations did not reflect the current market value of the securities. Kirkland participated with the portfolio manager in providing valuations for the troubled securities that did not reflect current market value, which caused the one of the funds to materially overstate its NAV.

B. RESPONDENT

Kirkland, a resident of Los Angeles, California, was a registered representative from 1988 through January 2001 and held Series 7, 24, 27 and 63 licenses until January 2001. Kirkland was a principal officer and director of a broker-dealer until the broker-dealer ceased operations in August 1999 and withdrew its registration in 2001.

C. RELATED ENTITIES AND PERSON

1. The broker-dealer (hereinafter referred to as the "Broker-Dealer") was registered with the Commission as a broker-dealer from July 1994 until it ceased operations in August 1999 and withdrew its registration effective March 2001. The Broker-Dealer was an investment banking firm specializing in restructurings and private placements for institutional clients.

2. Legg Mason High Yield Portfolio (the "High Yield Fund") is a series offered through Legg Mason Income Trust, Inc., an open-end investment company registered with the Commission since 1987 (File No. 811-0529). The High Yield Fund began operations in 1994. The High Yield Fund has an investment objective of providing a high level of current income and capital appreciation, had assets of $431 million as of May 31, 1998, and $218 million as of December 31, 2000, and invests its assets in high yield, fixed income securities.

3. U.S. High Yield Investments, N.V. (the "Offshore Fund") is part of a family of Legg Mason offshore funds. Established in 1996 as a limited liability company under Netherlands Antilles law, the Offshore Fund is available only to foreign investors. Its investment objective is to provide a high level of current income by investing primarily in high-yielding debt

obligations of U.S. issuers. It had assets of $259 million as of February 28, 1998, and $159 million as of February 29, 2000.

4. The investment adviser (hereinafter referred to as the "Investment Adviser") has been registered with the Commission as an investment adviser since 1971. The Investment Adviser is the investment adviser for the High Yield Fund and Offshore Fund (collectively, the "Funds").

5. The portfolio manager (hereinafter referred to as the "Portfolio Manager") was employed by the Investment Adviser and was the Funds' portfolio manager until she resigned in November 1998.

D. THE SALE AND PRICING OF THE NOTES BY KIRKLAND AND THE PORTFOLIO MANAGER

1. The Sale of Notes to the Funds

From July 1994 through April 1998, Kirkland participated in the sale to the Funds of over $34 million in notes-$30.2 million in notes, at a purchase price of $27.9 million, to the High Yield Fund, and $4.1 million in notes at par to the Offshore Fund. Kirkland participated in the sale of the notes through private placements, and the notes were held by either the High Yield Fund alone or with the Offshore Fund.

2. Kirkland's Participation in the Pricing of Notes Held by the Funds

a. The Pricing Procedures

To calculate NAV, the Funds' securities were priced daily. For publicly traded securities, the Funds used a service to price the securities. For securities that the service could not price, the Portfolio Manager was to obtain bid and ask quotes from two brokers. For the notes sold by the Broker-Dealer, the Portfolio Manager could not obtain two broker quotes because the notes were not traded. Instead, the Portfolio Manager, in discussions with Kirkland, set the price quotes for the notes.

Beginning in 1995, the Broker-Dealer, with Kirkland's consent, became involved in sending to the Funds' accountants the prices for securities held by the Funds that the service could not price. On a daily basis, the Portfolio Manager called one of the Broker-Dealer's analysts with price quotes. The Broker-Dealer analyst entered each quote on a spreadsheet as two bid and ask price quotes for each security, including the notes sold by the Broker-Dealer in which the price quotes came from discussions between Kirkland and the Portfolio Manager and not from two brokers. The Broker-Dealer then faxed the spreadsheet to the Funds' accountants.

In a letter dated March 14, 1997, Kirkland misrepresented to the Funds and the Investment Adviser the methodology they used in pricing the Funds' securities. In the letter, Kirkland stated that the Broker-Dealer "provides daily pricing for the [Funds.] Securities in each fund are priced in the following manner. Bid-ask quotations are solicited from at least two broker-dealers that trade the security. The mean of the bid prices and ask prices is then submitted for pricing purposes." In fact, Kirkland and the Portfolio Manager priced the notes that the Broker-Dealer had sold to the Funds themselves and did not obtain quotes from two broker-dealers.

b. The Issuers' Financial Troubles, the Roll Up Transactions and Kirkland's Participation in the Pricing

Five of the issuers, for which Kirkland participated in the sale of a total of $15.7 million par value notes to the High Yield Fund, had financial trouble at various points from 1996 through 1998. These financial problems resulted in the issuers' defaulting on interest payments, being forced into involuntary bankruptcy, and/or having all their assets taken away in foreclosure proceedings. Kirkland and the Portfolio Manager knew of these financial problems.

In early 1997, Kirkland and the Portfolio Manager proposed a roll up transaction in which the five notes would be contributed to a newly formed company controlled by Kirkland in exchange for notes and other securities issued by the newly formed company. Kirkland and the Portfolio Manager were specifically told that they could not proceed with the roll up transaction without first consulting with the parent company of the Investment Adviser and its legal counsel.

In 1997 and 1998, without consulting with the Investment Adviser's parent company or its legal counsel, Kirkland and the Portfolio Manager rolled up the troubled notes into two newly formed companies controlled by Kirkland. In these roll up transactions, the Broker-Dealer, with the participation of Kirkland, sold to the Funds $8.5 million in notes ($6 million for the High Yield Fund and $2.5 million for the Offshore Fund) issued by one of the companies and $5.6 million in notes ($4 million for the High Yield Fund and $1.6 million for the Offshore Fund) issued by the other company. Kirkland then had the first company use a portion of the $8.5 million proceeds to purchase from the three of the High Yield Fund's problem notes and had the second company use a portion of the $5.6 million proceeds to purchase two other of the High Yield Fund's problem notes. Kirkland then had the companies lend the remaining offering proceeds, a total of $1.62 million, to the Broker-Dealer's parent company. Unlike the original problem notes in which interest was due quarterly, the notes issued by the companies permitted interest to be paid in kind and therefore, at maturity. Following the roll up transactions, Kirkland managed the companies and their assets (i.e., the problem notes purchased from the High Yield Fund).

Kirkland's and the Portfolio Manager's pricing of the five problem notes and, subsequent to the roll up transactions, their pricing of the companies' notes failed to reflect the underlying notes' performance and the original issuers' financial condition and overstated the value of the notes. From August 30, 1996, through November 30, 1998, Kirkland and the Portfolio Manager overvalued the problem notes and the companies' notes by amounts ranging from $1.625 million to $3.705 million. As a result of this inflated pricing, Kirkland and the Portfolio Manager caused the High Yield Fund materially to overstate its NAV. In particular, by one reasonable measure, the High Yield Fund's NAV was overstated from August 30, 1996, through November 30, 1998, by amounts ranging from $.09 (or .52% of NAV) to $.20 (or 1.33% of NAV).

E. RESPONDENT'S VIOLATIONS OF THE FEDERAL SECURITIES LAWS

1. Antifraud Violations: Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder and Sections 206(1) and (2) of the Advisers Act

Section 17(a) of the Securities Act prohibits fraud in the offer and sale of securities, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraud in connection with the purchase or sale of any

security. Sections 206(1) and (2) of the Advisers Act prohibit fraud by an investment adviser upon any client or prospective client.

As a result of his conduct in pricing the problem notes and the companies' notes at inflated value and engaging in the roll up transactions, Kirkland willfully violated the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Kirkland also was a cause of, and willfully aided and abetted, violations of the antifraud provisions of Sections 206(1) and (2) of the Advisers Act.

2. NAV Violations: Rule 22c-1(a) of the Investment Company Act

Rule 22c-1(a), promulgated pursuant to Section 22(c) of the Investment Company Act, prohibits investment companies issuing redeemable securities from selling, redeeming or repurchasing any fund shares except at a price based on the current NAV. Under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder, current NAV calculations must be based on current market value or, if market quotations are not readily available, fair value as determined in good faith by the board of directors. As a result of his conduct in pricing the problem notes and the companies' notes, Kirkland was a cause of, and willfully aided and abetted, violations of Rule 22c-1(a).

3. Books and Records Violations: Section 34(b) of the Investment Company Act

Section 34(b) of the Investment Company Act prohibits any person from making any untrue statement of a material fact or to omit to state any material fact in any registration statement, application, report, account, record or other document required to be filed or transmitted pursuant to the Investment Company Act or keeping of which is required pursuant to Section 31(a) of the Investment Company Act. Section 31(a) of the Investment Company Act and Rule 31a-1(a) thereunder require registered investment companies to maintain and keep current the accounts, books and other documents that constitute the record forming the basis for their financial statements required to be filed pursuant to Section 30 of the Investment Company Act.

Kirkland was a cause of, and willfully aided and abetted, violations of Section 34(b) of the Investment Company Act by submitting to the High Yield Fund's accountants false prices for the notes, which prices were included in the High Yield Fund's NAV calculations and constituted records forming the basis for the High Yield Fund's financial statements.

IV.

Based on the foregoing, the Commission deems it appropriate in the public interest to accept the Offer submitted by Kirkland and impose the sanctions specified in the Offer.

Accordingly, IT IS HEREBY ORDERED that Kirkland shall cease and desist from committing or causing any violation and any future violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and (2) of the Advisers Act and Section 34(b) of the Investment Company Act and shall cease and desist from causing any violation and any future violation of Rule 22c-1(a) under the Investment Company Act.

IT IS FURTHER ORDERED that Kirkland shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $30,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312-0003; and (D) submitted under cover letter that identifies Kirkland as the Respondent and the file number of this proceeding, a copy of which cover letter and money order or check shall be sent to Sandra J. Harris, Associate Regional Director, Pacific Regional Office, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

IT IS FURTHER ORDERED that Kirkland is barred from association with any broker or dealer with the right to reapply for association after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission, and is prohibited from serving or acting as an employee, officer, director, member of advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor or principal underwriter, with the right to reapply for service in any such capacity with the Commission after three (3) years from the date of the Order.

By the Commission.

Jonathan G. Katz
Secretary

http://www.sec.gov/litigation/admin/33-8019.htm

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