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Video Lottery Terminals in New York State **What Is to Be Done?**

There's an old joke about the customer buying some lamb chops from a butcher. She asks the butcher the price of the lamb chops.

He says, "\$4.00 a pound."

She counters with, "\$4.00 a pound. The butcher on the next block charges \$3.00 a pound."

The butcher says, "Why don't you buy it from the guy on the next block?"

The customer responds with, "He's out of lamb chops."

To which the butcher responds, "When I'm out of lamb chops, I charge \$2.00 a pound."

That about sums up New York's experience with video lottery terminals. Nobody is buying the lamb chops, (the VLT's) and the butchers (the racing industry) are starving.

In short, there are three major problems affecting VLT's.

1. The level of customer play of the video lottery games has been disappointing.
2. Revenue to the racetracks under New York's statutory distribution formula is at such a low level that it is discouraging significant investment in New York's racetracks and racing industry. With other states moving into the racino industry and the likelihood of additional Indian casinos, it will be difficult for New York's racetracks to compete.
3. There is a need to shore up the constitutionality of the provisions under which the breeders and the horsemen share a vendor's fee with the racetracks.

The Machines Themselves

Per machine revenue of the VLT's is well below traditional national standards. This is occurring despite the fact that New York's VLT's are theoretically paying out 92% of betting handle. By contrast, the tribal casinos in Connecticut are paying out

approximately 91.8% of betting handle,¹ and the Atlantic City casino are also on the average paying out slightly less than 92%.² So we have the odd situation where New York's machines are paying off at a rate favorable to that of our competition, while per machine revenue in New York is about 54% of the national standard.³

Something clearly is out of kilter here, and the games that New York offers need to be increased and improved.⁴ The catch is that immediate improvement of these games will hinge on the eventual decision of the Court of Appeals in Dalton v. Pataki.⁵

If the Court of Appeals makes it difficult for the Lottery Division to add additional games that might be based not totally on chance, then New York's VLT's may be at a close to permanent disadvantage against its competition. As additional Indian casinos become authorized in New York State, this battle for the machine betting dollar may become even further slanted against the racetracks.

Greater efforts must be made to improve New York's games so that patrons will be encouraged to play these games. If it will be difficult to change the essential character of the games, it would make sense to increase the vendor fee paid to the racetrack to make up for the limited customer appeal of the games themselves. At the very least, the State ought to factor in the limited current customer interest in these games in establishing a vendor fee.

Vendor Fee

Since I'm trying to make this memorandum as informal as possible, let me share some basic anecdotes I've accumulated over the past three and a half years of VLT, maneuvering. When the VLT share was set at basically 12.5% to the tracks, there was talk that the tracks could conceivably make it at 17.5%. After the fee went up, there was talk that the tracks needed 20%. Now that the tracks have 20%, there is more talk that the tracks need 30% or even 40% of gross terminal revenue to survive.⁶

I'm not an economist, but everything I've seen shows that the tracks aren't going to make it at the current New York levels. No state is giving tracks anywhere near the 20% levels of New York State. The lowest that the horse tracks are making from racinos is approximately 40% in Pennsylvania. As one Penn National representative has recently

¹ See <http://www.dosr.state.ct.us/PDFFolder/Fosltweb.pdf> and <http://www.dosr.state.ct.us/PDFFolder/Fosltweb.pdf>.

² <http://www.americancasinoguide.com/SlotPayback/slotinfo.shtml#NEW%20JERSEY>.

³ This figure is based on an estimate that the average per machine revenue is \$250 per machine per day while the New York average appears to be \$135 per machine per day.

⁴ One IGT executive has stated, "I'm still disappointed in our performance in New York. It is not up to our internal goals and expectations. We have a variety of alternatives underway to improve that performance and so we will continue to work on that on a regular basis." "FY'05 Q2 Earnings – Final," Fair Disclosure, September 21, 2004.

⁵ Dalton v. Pataki, 11 A.D.3d 62 (3rd Dept. 2004)

⁶ As one anecdote, last week, I was asked by the Miami Herald what a fair share to the tracks would be. I said a net of 40% - which would not include the revenue to the horsemen and breeders. I quickly received a call suggesting that I was low-balling the percentage of revenue that the tracks deserved to receive.

stated, “New York, of course, has tried its hand at slots at race tracks, but disastrously so. I mean the legislation is essentially unworkable.”⁷ One market analyst in talking about Florida has asked whether “those people are realistic and do recognize that they want you to get going and build nice facilities and add to the neighborhood and not just be at a confiscatory New York State 80 percent kind of situation?”⁸

Even in Pennsylvania, there has been considerable belief that the return to the house will limit investors. “Gambling companies have complained that the ... share the law allows casino owners - combined with a \$50 million licensing fee - will detract from their ability to build glitzy and attractive gambling halls.”⁹ “The high rate of taxation imposed on slots by the Pennsylvania law - more than 52 percent of gross slot revenue - could force companies to scale back such investments and build simpler projects, speakers said.”¹⁰

Now there are a number of reasons why the tax rate for video lottery terminals in New York should be higher than in most gambling jurisdictions.

1. New York is only legalizing machines and not the far more labor intensive table games.
2. The Lottery Division is supplying the machines and monitoring the system.
3. Tracks should not be overly rewarded for failing in their core business.
4. The principal purpose of the legislation is to provide revenue for education.
5. The reason for using racetracks as the site of the video lottery terminals was to benefit the entire racing industry and not merely the owners of the racetracks.

But even if you believe that there are reasons for a fairly high tax rate, the tax rate in New York is excessive. It has, in fact, made New York State a non-starter in the racino world.

⁷“Q4 2004 Penn National Gaming Earnings Conference Call – Final,” Fair Disclosure Wire, February 3, 2005.

⁸ Larry Klatzkin quoted in “Q2 2005 Isle of Capri’s Casinos Earnings Conference Call,” Fair Disclosure, November 12, 2004.

⁹ Marc Levy, “Gambling Giants a ‘Good Thing’ for Pa. Slots Commission Chair Says,” Associated Press, February 11, 2005.

¹⁰ Nathan Gorenstein, “Casino-Related Uses Are Cited as Being Vital For the City,” Philadelphia Inquirer, February 2, 2005 Pg. B05. See also “Casinos will ‘look carefully’ before jumping into Philadelphia and Pennsylvania because of a requirement that more than 50 percent of gross revenue be turned over to state and local governments, said Brian R. Ford, a partner at Ernst & Young, a consulting firm.” Gorenstein, “Despite High Tax, Philadelphia Area Holds Appeal for Slot Venues,” Philadelphia Inquirer, January 12, 2005.

To remedy this, the rate of return to the tracks has to increase. It is logical that the tax rate ought to be established on a sliding scale basis. This approach suggested in Senate Bill 2424 makes considerable sense especially since the “percentage of overhead costs incurred by smaller race tracks (many of which are located Upstate) that install VLT machines will be larger percentage of total revenue collected than for larger tracks located near major metropolitan areas.”¹¹ Additionally given the strong assumption that per machine revenue for the metropolitan New York racetracks will likely be twice that of the upstate tracks, it makes further sense to establish a program under which the upstate tracks pay a far lower effective tax than the downstate tracks.

Thus, you could establish a retention rate for the tracks close to 40% on the first \$50 million of gross terminal income, 35% on the next \$50 million, and 31% on anything over \$100 million.¹² In addition, the 10% allocated to the Lottery Division for expenses could easily be reduced to 8% for the over \$100 million bracket, so there would be no possible income loss to the State on this revenue.

In the event that the State is worried about revenue loss from this slight adjustment in the VLT rates, it could simply authorize a significant racino at Belmont. Having been present in the legislature at the time of the creation of this legislation, there was never an adequate rationale given for the exclusion of Belmont. There was speculation that the Senate wished to protect Nassau OTB, that the Assembly did not want to add a second racino facility that might technically be located (at least in part) within New York City, and that NYRA wished to maintain the pristine character of beautiful Belmont. In any event, there seems to be little current reason for believing that these explanations carry much weight today and should prevent Belmont from receiving racinos. Adding Belmont would also have the benefit of obviating much of the need for the free-standing video lottery facilities proposed in the Governor’s budget bill.¹³

Sharing the Vendor Fee

Returning to the legislative discussions of October 2001, it is my recollection that the negotiators played little attention to the problem identified by the Appellate Division in Dalton regarding the track/vendor sharing the vendor fee with horsemen and breeders. The concern was whether a court might question the propriety of the amount of the vendor fee. Once the vendor fee was established, it was thought that the legislature could direct it as appropriate, since this would not constitute any improper divvying up of the “net proceeds”¹⁴ of the State lottery. There are so many provisions of the Racing, Pari-Mutuel Wagering and Breeding Law where revenues from track operations, OTB’s and simulcasting are shared by the horsemen and the tracks that it seemed that the horsemen and the tracks are de facto partners in the operation of a racetrack.

¹¹ New York State Senate, Introducer’s Memorandum In Support, S. 2424, Senator Larkin.

¹² This could be achieved by a higher vendor fee or a combination of the current vendor fee and a promotional fee as suggested by S. 2424.

¹³ S.993, A. 1923.

¹⁴ New York State Constitution, Article 1, Section 9.

It may well be that that the State Court of Appeals will not agree with the position of the Appellate Division on the net proceeds of the lottery. Nonetheless, if the Court of Appeals affirms the Appellate Division on this point, there is probably a need for pop-up legislation. This legislation would pop up - and take effect – if, and only if, the Court of Appeals affirmed the Appellate Division on this point.

Some approaches to deal with the net proceeds issue are unlikely to succeed in handling the problem. The approach in the Budget Bill¹⁵ would likely be unsuccessful. That bill simply authorizes a contract between the Lottery Division and the racetracks under which the breeders and the horsemen receive a designated portion of the vendor fee. It would be difficult to locate a court naïve enough to find any significant difference between that provision and existing §1612.

Additionally, suggested attempts to establish a State VLT marketing fee fund - out of which some allocations would be directed to purses and breeders – raises a whole host of problems. First of all, a court looking at this proposal would be unlikely to believe that there was any significant difference between this allocation and the current allocation found improper in Dalton. Further, it raises the possibility that payment of a state moneys to purses is an improper gift of State property under Article 7, §8 of the State Constitution.¹⁶ In any event, creation of this fund would likely spawn a constitutional challenge, which could only further delay VLT implementation in New York.

Finally, the history of legislative allocations to purses in the states in recent years has not been a kind one. Some states¹⁷ that have supplemented purses through State funding have simply ended or limited this funding when the State's finances got tighter, and/or when there was less political pressure on the legislature to maintain purse levels.

If there is a constitutional problem in allocating lottery revenues to breeders and horsemen, then the simplest solution is to give the moneys to the racetrack/vendor and require the racetrack to contract with the horsemen and breeders. In fact, the Racing and Wagering Board basically requires a contract between the tracks and the horsemen – with the exception of the NYRA tracks – in order for a track to obtain its annual license.

In desperation, there is finally the possibility of making the VLT vendor a separate corporation formed through a joint venture of the racetrack and its recognized horsemen's group. This would make the horsemen formally part of the vendor's group and would end any need for the State to create a separate allocation to horsemen. The joint venturers would be free to establish the terms of any purse allocation amongst themselves.

¹⁵ See note 13 supra, amendments to §1612 of the Tax Law.

¹⁶ The situation might be different for the breeding funds under Saratoga Harness Racing Assoc. v. Agriculture & New York State Horse Breeding Development Fund, 22 N.Y.2d 119 (1968)

¹⁷ Maryland and New Jersey come to mind.

In short, if allocating funds from VLT's to horsemen is a constitutional problem, changing the nomenclature of the artifices through which the horsemen obtain revenue will not solve the problem. You either have to give all the money to the vendor or make the horsemen part and parcel of the vendor's group.

I apologize for the informal tone of much of this memo, but I thought that informality at times might strengthen some of my points. I simply don't want horse racing in New York State to turn into a piece of meat.