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Commonwealth of Kentucky

Court of Appeals

NO. 2011-CA-000164-MR

THE FAMILY TRUST FOUNDATION
OF KENTUCKY, INC., d/b/a THE
FAMILY FOUNDATION — APPELLANT

APPEAL FROM FRANKLIN CIRCUIT COURT
DIVISION II
v. HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 10-CI-01154

THE KENTUCKY HORSE RACING COMMISSION;
THE KENTUCKY DEPARTMENT OF REVENUE;
APPALACHIAN RACING, LLC; LEXINGTON
TROTS BREEDERS ASSOCIATION, LLC;
KENTUCKY DOWNS, LLC; CHURCHILL DOWNS
INCORPORATED; ELLIS PARK RACE COURSE,
INC.; KEENELAND ASSOCIATION, INC.;
PLAYERS BLUEGRASS DOWNS, INC.; and
TURFWAY PARK, LLC — APPELLEES

OPINION
VACATING AND REMANDING

** ** ** ** **

BEFORE: COMBS AND STUMBO, JUDGES; LAMBERT,[1] SENIOR JUDGE.

[1] Senior Judge Joseph E. Lambert sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

LAMBERT, SENIOR JUDGE: It could not be gainsaid that thoroughbred breeding and racing occupy a central role in Kentucky life. The thoroughbred industry is deeply imbedded in our history, culture and economy. In recent years, it has been widely reported and seems to be true that the industry has fallen on hard times. A primary contention is that Kentucky racing purses have not kept pace with those offered by tracks in other states rendering Kentucky tracks competitively disadvantaged. The thoroughbred industry has repeatedly engaged the political branches of state government seeking expanded gaming revenue sources, but little success has been achieved.

In pursuit of new revenue, Kentucky thoroughbred race tracks, the state racing commission and gaming vendors developed a gaming product whereby parties may wager on "historical" races by means of a device that looks like a slot machine. Although the trial court record and the record on appeal are underdeveloped, it seems that a patron may use the devise by inserting money or its equivalent, selecting a numbered "horse" in a "historical" race, and watching all or part of a race run at another place and time. The patron wins or loses his bet based on the outcome of the historical race.

The overarching issue presented is whether wagering on historical races violates the provisions of KRS Chapter 528 which variously proscribe gambling. Prior to reaching that issue, if at all, we find it necessary to provide background context and address certain preliminary issues.

This appeal is by the Family Trust Foundation of Kentucky, Inc., (Family Foundation) from an order of the Franklin Circuit Court granting Appellees' petition for declaration of rights. As Appellees sought, the trial court upheld regulations adopted by the Kentucky Horse Racing Commission (the Commission) authorizing "historic racing." Upon review and for reasons hereinafter stated, we vacate and remand for further proceedings.

On January 5, 2010, the Attorney General of Kentucky responded to a request by a member of the General Assembly regarding the permissibility of "Instant Racing" under Kentucky law. The Attorney General opined that while nothing in Kentucky's statutes prohibited Instant Racing, it was nonetheless impermissible under existing Racing Commission Regulations. Thereafter, the regulation was amended and this claim brought in the trial court.

To briefly elucidate, Instant Racing or historic racing does not occur at the moment a patron observes it. It actually consists of a video of a race that was run in the past. Bettors are allowed to wager on the outcome based on a provided data set. No information is furnished to the patron making the wager that would identify the race or its outcome.

Per regulations adopted by the Racing Commission, operators of the game must comply with the following:

> (d) Prior to making his or her wager selections, the terminal shall not display any information that would allow the patron to identify the historical race on which the race was run, the names of the horses in the race, or the names of the jockeys that rode the horses of the race;

> (e) The terminal shall make available true and accurate past performance information on the historical horse race to the patron prior to making his or her wager selections. The information shall be current as of the day the historical race was actually run.

Amended 810 KAR 1:011, Section 3(7).

On the day the new regulation was adopted, the Commission, the Department of Revenue, and several horse racing organizations[2] filed a petition for declaration of rights in the Franklin Circuit Court. The petition asked the court for a judicial determination of three legal issues:

> 1) whether the filing of administrative regulations authorizing pari-mutuel wagering on historical horse races is a valid and lawful exercise of the Commission's statutory authority to regulate pari-mutuel wagering on horse racing;
> 2) whether the licensed operation of pari-mutuel wagering on historical horse races, as authorized by the amended regulations, violates the statutory prohibitions on gambling contained in Kentucky's Penal Code (Kentucky Revised Statutes (KRS) Chapter 528; and
> 3) whether the Department of Revenue correctly determined that revenue generated by pari-mutuel wagering on historical horse races is subject to the pari-mutuel tax (as set forth in KRS 138.510) pursuant to its statutory authority to interpret and enforce the tax laws of the Commonwealth.

On August 23, 2010, Family Foundation filed a motion to intervene, which the trial court granted on September 2, 2010. Family Foundation argued that the amended regulations permitting historic racing were improper and violative of Kentucky's gambling laws. The trial court held a hearing on December 14, 2010,

[2] Appalachian Racing, LLC; Churchill Downs, Inc.; Ellis Park Race Course, Inc.; Keeneland Association, Inc.; Kentucky Downs, LLC; Lexington Trots Breeders Association, LLC; Players Bluegrass Downs, Inc.; and Turfway Park, LLC.

and determined that the regulations complied with Kentucky law. Family Foundation appealed to this court.

Family Foundation first argues that the circuit court did not have jurisdiction to issue its opinion and order because there was no justiciable controversy. Since justiciability is purely a question of law, our review is *de novo*. *Fugett v. Commonwealth*, 250 S.W.3d 604, 616 (Ky. 2008). We are gravely concerned about a practice whereby a group of parties without any antagonistic interest may formulate an agreed statement, submit it to a court and obtain judicial approval of the outcome they seek. Yet, that seems to be precisely what KRS 418.020 allows.

Family Foundation is correct in asserting that "questions that . . . are purely advisory or hypothetical do not establish a justiciable claim" over which a circuit court has jurisdiction. *Doe v. Golden & Walters, PLLC,* 173 S.W.3d 260, 270 (Ky. App. 2005) (Internal citations omitted). However, this court has held that under KRS 418.020, "there can be a 'justiciable controversy when an advance determination would eliminate or minimize ***the risk of wrong action or mistakes*** by any of the parties." *McConnell v. Commonwealth*, 655 S.W.2d 43, 45 (Ky. App. 1983) (Emphasis added). The *McConnell* court also emphasized that adjudication is appropriate when a useful public purpose can be served -- especially when the concern is immediate and prominent. *Id.* at 46. When determining the existence of justiciability, we must consider the "appropriateness of issues for decision and the hardship of denying relief." *Id*.

In this case, we are persuaded that it was acceptable for the lower court to entertain and to adjudicate the petition for declaratory rights. The racing associations were rightfully concerned about criminal consequences for themselves and their patrons (members of the general public) if historic racing were successfully challenged and determined to be illegal. This Court and the Supreme Court of Kentucky have both held that criminal safeguards are appropriate subject matter for the declaration of rights pursuant to KRS 418.020. *See Hammond v. Smith*, 930 S.W.2d 408 (Ky. App. 1996); *Chambers v. Stengel*, 37 S.W.3d 741 (Ky. 2001). The concern of the legitimacy is both immediate and prominent, thus, satisfying the *McConnell* criteria. Additionally, the regulations have been enacted, and several race tracks have already implemented historic racing. The taxation at issue is occurring contemporaneously with this litigation and appeal, and the Department of Revenue is receiving funds accordingly.

In addition to relying on the sound reasoning of *McConnell,* we also conclude that judicial review was proper under *Legislative Research Comm'n v. Brown*, 664 S.W.2d 907 (Ky. 1984) (the *LRC* case). In that case, the Supreme Court of Kentucky addressed the issue of separation of powers in the context of the LRC's authority to review administrative regulations. It observed that "[t]he adoption of administrative regulations necessary to implement and carry out the purpose of legislative enactments is executive in nature and is ordinarily within the constitutional purview of the executive branch of government." *Id.* at 919. It also held that the review of whether regulations comport with statutory directives and

legislative intent belongs to the judiciary. *Id.* The *LRC* case followed the *McConnell* case chronologically within a matter of months and reiterated *McConnell* substantively.

Based on these cases and the course of administrative actions taken, we conclude that the court acted within its jurisdiction in deciding the issues presented in the petition for declaratory rights. This is true because at the time the petition was filed, the Commission had unanimously approved the amendments to the regulations. Furthermore, during the pendency of the petition in circuit court, the Commission proceeded with the amendments according to KRS Chapter 13A. It published notice of a public hearing, which was held on September 29, 2010. Written comments were accepted until September 30, 2010. On October 15, 2010, the Committee submitted its statement of consideration to the compiler, including responses to the comments it had received. Therefore, by the time that the circuit court held its hearing on December 14, 2010, the Executive Branch's actions were completed. Thereafter, required review was conducted by the LRC and the General Assembly.

The Supreme Court of Kentucky has unequivocally held that meaningful review of the statutory compliance of regulations should be conducted by the Judicial Branch. Our view in this regard is strengthened by the appearance of Family Foundation in this litigation. Wisely, the circuit court allowed Family Foundation to intervene as an opposing party and it has litigated this case as a bona fide, competent adversary. But for Family Foundation, our view might be

different. After reading the parties' briefs and hearing oral argument, we have no doubt that this case is adversarial.

Family Foundation next contends that the trial court erred in refusing to permit it to engage in discovery. On July 26, 2010, before Family Foundation intervened, the circuit court entered a scheduling order requiring briefs within 30 days. After Family Foundation's intervention was allowed, it asked the court to modify the prior order to permit time for discovery. The circuit court declined to modify its prior order and denied the request for discovery. It viewed the questions posed by Appellees as purely questions of law, and on this basis, discovery was denied.

The role of discovery in the litigation process can be hardly overstated. Discovery is the process whereby parties learn the strengths and weaknesses of their cases, formulate issues and learn the facts. As lawyers and judges are well aware, most cases are decided on the facts discovered and admitted in evidence. Recognizing this, CR 26.02 broadly defines the scope of discovery in civil litigation. It provides that

> Parties may obtain discovery regarding any matter, not privileged, which is relevant to the subject matter involved in the pending action, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any books, documents, or other tangible things and the identity and location of persons having knowledge of any discoverable matter. It is not ground for objection that the information sought will be inadmissible at the trial if the information sought appears

> reasonably calculated to lead to the discovery of admissible evidence.

Family Foundation contends that issues of fact exist concerning the nature of wagers placed on electronic gaming machines featuring historical horse races, including the manner in which wagers are pooled and how the odds are calculated. It also sought to probe the difference between live racing and video re-plays of historical horse races; *i.e.*, whether a video re-play is a horse race as required by statute. Family Foundation contends that these are factual questions permeated with nuance that entitled it to conduct pre-trial discovery. For emphasis, Family Foundation points to the circuit court's own unanswered question posed at the hearing concerning computation of the payoff where the patron is a winner; *i.e.,* whether the odds were pre-determined as of the date of the historical race or were pari-mutuel with respect to the time of the instant race wager. Family Foundation argues that these issues of fact defeat the court's characterization of all issues as being purely issues of law. Therefore, it contends that the court erred in failing to recognize these issues of fact and to allow it to conduct discovery.

We agree that the parties had a right to develop proof and to present evidence to establish that the wagers made by patrons at electronic gaming machines do or do not meet the definition of pari-mutuel wagering on a horse race. These are complex questions, and the parties are entitled to ample discovery in an effort to present the evidence. We conclude that the request for discovery by

Family Foundation was relevant and necessary to the court's determination and that the court's denial of discovery constituted an abuse of discretion.

By virtue of the absence of any discovery, the record before us is without a meaningful evidentiary basis to support the judgment of the trial court. Appellate review is thus impossible. As such, we are unable to address the merits of the remaining issues. Accordingly, the judgment of the Franklin Circuit Court is vacated and this cause remanded for further proceedings not inconsistent herewith.

STUMBO, JUDGE, CONCURS.

COMBS, JUDGE, DISSENTS AND FILES SEPARATE OPINION.

COMBS, JUDGE, DISSENTING: I agree with the disposition of most of the issues discussed in the majority opinion: justiciability; the propriety of using the declaratory judgment act; and the statutory delegation of authority to the Racing Commission to promulgate regulations pertaining to the horse racing industry. However, I agree with the trial court that all issues before it were purely legal issues precluding the need for -- or recourse to -- discovery. Therefore, I file this dissent.

Family Foundation has made excellent and persuasive arguments about virtually every aspect of instant racing. Nonetheless, the narrow legal issue remains: did the Racing Commission act within the scope of its broad delegation of authority by the General Assembly pursuant to KRS 230.215(2), which provides as follows:

> It is hereby declared the purpose and intent of this chapter in the interest of the public health, safety, and welfare, to vest in the racing commission ***forceful control*** of horse racing in the Commonwealth with the ***plenary power to promulgate administrative regulations*** prescribing conditions under which ***all legitimate horse racing and wagering thereon*** is conducted in the Commonwealth so as to encourage the improvement of the breeds of horses in the Commonwealth, to regulate and maintain horse racing at horse racing meetings in the Commonwealth of the highest quality and free of any corrupt, incompetent, dishonest, or unprincipled horse racing practices, and to regulate and maintain horse racing meetings in the Commonwealth so as to dissipate any cloud of association with the undesirable and maintain the appearance as well as the fact of complete honesty and integrity of horse racing in the Commonwealth. (Emphasis added.)

The Franklin Circuit Court properly addressed this legal issue and found that the Commission indeed had acted as intended and as empowered by the General Assembly.

Because the majority opinion held that discovery should be conducted, it stopped short of addressing numerous other issues raised in the briefs. Because I believe that all issues before the trial court were purely legal in nature, I have endeavored to address the remaining issues in this dissent.

Family Foundation principally contends that the amendments to the regulations lacked statutory authority because historic racing is not an exercise of pari-mutuel wagering. Family Foundation claims that the Commission acted beyond the scope of its legitimate statutory authority by embarking into uncharted territory (historic racing) that does not encompass pari-mutuel wagering.

Pari-mutuel wagering was invented in the 1870's by a French *parfumier* (perfume manufacturer) Pierre Oller. Joan S. Howland, *Let's Not "Spit the Bit" in Defense of "The Law of the Horse": The Historical and Legal Development of American Thoroughbred Racing*, 14 Marq. Sports L. Rev 473, 496 (2004). It is a system of wagering in which the bettors' money is pooled and then divided among the winners. The odds are determined by the amount of money wagered on each horse; the more that is wagered, the lower are the odds and the payout to the winner. *Id*. Critical to the legality of the system is that the bettors wager **among themselves** rather than against the operator of the pool (*i.e.,* the Racing Association or the "house").

In 1881, the predecessor of our Supreme Court examined pari-mutuel wagering and held that it was lawful in Kentucky because the operator of the pool did not risk his own funds. The wagering was among the bettors and not against the operator – although the operator received a commission. *Commonwealth v. Simonds*, 79 Ky. 618 (Ky. 1881).

Horse tracks in Europe and America experimented with pari-mutuel racing in the 1880's and 1890's, but it was not used widely. Howland, 14 Marq. Sports L. Rev at 497. Then, in 1908, wagering at the Kentucky Derby was threatened by Louisville Mayor James Grinstead, who moved to enforce a state law that made bookmaking illegal. *Id*. In response, Colonel Matt Winn, the manager of Churchill Downs, moved for a restraining order. *Id*. The Kentucky Court of Appeals subsequently found that pari-mutuel wagering was not subject to the

bookmaking statute; therefore, it was legal in the state of Kentucky. *Grinstead v. Kirby*, 110 S.W. 247 (Ky. 1908). Colonel Winn promptly resurrected some dusty pari-mutuel machines from the basement of Churchill Downs, and wagering was carried on at the 1908 Kentucky Derby. Howland, *supra*.

Pari-mutuel wagering became the standard method used by horse tracks across the country. *Id.* By 1931, the predecessor to our modern-day Supreme Court described its operation in *Commonwealth v. Kentucky Jockey Club,* 238 Ky. 739, 38 S.W.2d 987, 991 (Ky. 1931):

> French pool or Paris mutual is a machine or contrivance used in betting …. In French pool the operator of the machine does not bet at all. He merely conducts a game, which is played by the use of a certain machine, ***the effect of which is that all who buy pools on a given race bet as among themselves***; the wagers of all constituting a pool going to the winner or winners. The operator receives 5 per cent of the wagers as his commission. (Emphasis added.)

Pari-mutuel racing has been adopted by the Association of Racing Commissioners International (RCI). Its model rules define pari-mutuel wagering as "a form of wagering on the outcome of an event in which all wagers are pooled and held by a pari-mutuel host for distribution of the total amount, less the deductions authorized by law, to holders of tickets on the winning contestants." RCI Model Rules 004-007(M). Additionally, Kentucky law defines pari-mutuel wagering as "a system or method of wagering approved by the commission in which patrons are wagering among themselves and not against the association and

amounts wagered are placed in one or more designated wagering pools and the net pool is returned to the winning patrons." 810 KAR 1:001(48).

The General Assembly has codified its intention "to foster and encourage the business of legitimate horse racing with pari-mutuel wagering thereon in the Commonwealth on the highest possible plane." KRS 230.215(1). In 1906, the General Assembly established a state racing commission to oversee racing and wagering in the Commonwealth. *State Racing Comm'n v. Latonia Agric. Ass'n*, 123 S.W. 681 (Ky. 1909). As mentioned previously in this opinion, the Commission has been vested with "***plenary*** power to promulgate administrative regulations prescribing conditions under which all legitimate horse racing and wagering thereon is conducted in the Commonwealth[.]" KRS 230.215(2). (Emphasis added.) Citing the definition of *plenary* from Black's Law Dictionary at 1154 (6th ed. 1990) as "full, complete, absolute, perfect, unqualified," the Commission aptly noted in its brief that: "It is hard to imagine a greater delegation of authority over horse racing and pari-mutuel wagering …." Commission's Brief, p. 11. KRS 230.361 directly and sweepingly authorizes the Commission to regulate pari-mutuel wagering on licensed premises.

The requirements for historical racing fall within the meaning of pari-mutuel racing. First, it may only be conducted by associations who are licensed to conduct live horse race meets. 810 KAR 1:011(3)(2). The payouts are prescribed by regulation:

> (1)(a) A wager on an historical horse race, less deductions permitted by KRS Chapter 230 or 810 Chapter 1, shall be placed in pari-mutuel pools approved by the commission.
> (b) A payout to a winning patron shall be paid from money wagered by patrons and shall not constitute a wager against the association.
> (c) An association conducting wagering on an historical horse race shall not conduct wagering in such a manner that patrons are wagering against the association, or in such a manner that the amount retained by the association as a commission is dependent upon the outcome of any particular race or the success of any particular wager.
> (2) An association shall only pay a winning wager on an historical horse race out of the applicable pari-mutuel pool and shall not pay a winning wager out of the association's funds. Payment of a winning wager shall not exceed the amount available in the applicable pari-mutuel pool.
> (3) An association offering wagering on an historical horse race shall operate seed pools in a manner and method approved by the commission as set forth in 810 KAR 1:120.[3] For each wager made, an association may assign a percentage of the wager to seed pools. The seed pools shall be maintained and funded so that the amount available at any given time is sufficient to ensure that a patron will be paid the minimum amount required on a winning wager.
> (4) An association shall provide the funding for the initial seed pool for each type of exotic wager. The funding for the initial seed pool shall be non-refundable and in an amount sufficient to ensure that a patron will be paid the minimum amount required on a winning wager.

810 KAR 1:011(4).

Thus, historic races clearly fall within the scope and rules of pari-mutuel betting. Although the participants bet on different races, their money is nonetheless being pooled. Several types of exotic bets (which have not been

[3] This regulation governs exotic wagering.

challenged in court) have been available at Kentucky's race tracks for many years. These include Daily Doubles and Pick Six wagers, which involve multiple races and often take place over the course of multiple days.

Family Foundation argues on the contrary that the use of seed pools indicates that historic racing does not come within the definition of pari-mutuel betting. However, the seed pools are a safeguard against "minus pools," which occur when "the amount of money to be distributed on winning wagers exceeds the amount of money contained in the net pool." 810 KAR 1:001(41). The seed pool is funded by the patrons -- except for the initial seed pool, which is funded by the associations. 810 KAR 1:001(33). The initial seed pool is non-refundable, a fact that distances the association from it. No statutory or case authority has been cited that indicates any illegality with the seed pools. Thus, there is no basis to conclude that historic racing does not involve pari-mutuel wagering. I cannot agree that the trial court erred on this issue.

Family Foundation further contends that the historic racing regulations are illegal because the instant racing terminals are illicit "gambling devices" pursuant to KRS 528.010(4). Once again, I agree with the reasoning of the trial court, which correctly noted that KRS 436.480 ***exempts*** pari-mutuel wagering from the provisions of KRS Chapter 528. Therefore, the critical issue is whether the wagering is pari-mutuel – regardless of the mechanism involved. Since I agree with the trial court that historical racing is pari-mutuel in nature, it comes within the governance of KRS Chapter 230. KRS 436.480 unequivocally provides that

"KRS Chapter 528 shall not apply to pari-mutuel wagering authorized under the provisions of KRS 230." I would note again that concern for possible criminal repercussions of KRS Chapter 528 was one of the compelling reasons underlying the filing of the declaratory action as a matter of prudence and foresight for patrons wagering under the new regulations.

Family Foundation also contends that the historic races violate KRS 230.070 and KRS 230.080 because they are anonymous. KRS 230.070 prohibits entering a horse in a competition under an assumed name. KRS 230.080 prohibits the change of a horse's name after it has participated in a contest. However, neither of these statutes is applicable to historic racing. Both statutes concern the horse's name at the time of the live competition. Historic races only include races that: 1) were previously run at licensed pari-mutuel facilities in the United States; 2) concluded with official results; and 3) concluded without scratches, disqualifications, or dead-heat finishes. 80 KAR 1:001(30) Any horses that had violated rules involving name changes would have been disqualified, rendering the race ineligible for use in historic racing. Thus, the Commission's authorization of a horse for historic racing purposes presumes the qualification of the horse *ab initio* in the live race that later becomes the video.

However, I do agree with Family Foundation that it is improper for the Department of Revenue to collect excise taxes on the historic races. KRS 138.150(1)(a) authorizes the Department of Revenue to collect an excise tax "on all tracks conducting pari-mutuel wagering on ***live*** racing under the jurisdiction of

the commission." (Emphasis added). The tax is imposed on the daily live handle. The daily live handle is:

> the total amount wagered at a track on ***live racing*** and does not include money wagered:
> (a) At a receiving track;
> (b) At a simulcast facility;
> (c) On telephone account wagering;
> (d) Through advance deposit account wagering; or
> (e) At a track participating as a receiving track or simulcast facility displaying simulcasts and conducting interstate wagering as permitted by KRS 230.3771 and 230.3773.

KRS 138.511(3). The lower court found historic racing to be synonymous with live racing because the bettor does not know the outcome. I cannot agree with this reasoning.

Statutory interpretation is based on plain meaning of statutes. *Commonwealth v. Garnett*, 8 S.W.3d 573, 576 (Ky. App. 1999). A broadcast that has been video-recorded by definition is not live. No other construction of the word *live* is possible. Furthermore, the regulations promulgated by the Commission itself clearly differentiate between live racing and historic racing.

In order for the revenue from historic racing to become taxable, an amendment of the revenue statute is required. And that amendment is beyond even the plenary power of the Commission to regulate and belongs solely to the General Assembly.

Family Foundation last contends that the historic racing regulations are improper because they constitute special legislation, which is prohibited by

sections 59 and 60 of the Kentucky Constitution. However, those provisions apply to the acts of the General Assembly. The Commission is a division of the Executive branch of the Commonwealth and is not subject to those constitutional provisions. Furthermore, special laws relate to particular persons while general laws relate to a class. *Johnson v. Commonwealth ex rel. Meredith*, 165 S.W.2d 820, 825 (Ky. 1942). In this case, the regulations relate to the class of racing associations in the Commonwealth rather than individual, specific associations. Therefore, I am not persuaded that the regulations constitute special regulation that is prohibited by the Constitution of Kentucky.

In summary, I would affirm the ruling of the Franklin Circuit Court that the historic racing regulations are a legitimate exercise of the authority of the Kentucky Horse Racing Commission and that they constitute pari-mutuel wagering. I would vacate as to the Revenue Cabinet on the issue of taxability of revenue generated by historic races and remand for entry of judgment on this issue alone.

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