

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: RICHARD DOYLE
City Attorney

SUBJECT: Settlement of Cardroom
Litigation

DATE: March 10, 2009

RECOMMENDATION

It is recommended that the City Council:

- a) Authorize the City Attorney to execute the litigation settlement agreements with Sutter's Place, Inc., dba Bay 101 and Garden City, Inc.
- b) Approve an ordinance revising Title 16 of the San José Municipal Code, Gaming Control Regulatory Program, to clarify and enhance the scope, terms, conditions and procedures of regulations of cardrooms and funding sources, and to make technical changes to the Title.
- c) Adopt a resolution of the Council of the City of San José initiating proceedings on its own motion pursuant to the provisions of Section 20.120.010 of Chapter 20.120 of Title 20 of the San José Municipal Code to amend sections 20.40.100, 20.50.100, 29.90.060, add a new Part 13.5 to Chapter 20.80, and add a new section 20.200.995 of said Title 20 to provide for the appropriate location of relocated cardrooms, setting a public hearing thereon, and referring said proposed Title 20 amendments to the Planning Commission for report or recommendation.
- d) Adopt a resolution amending Resolution No. 72737 (the Schedule of Fees) as amended, to decrease cardroom table fees for Fiscal Year 2008-2009 to \$24,482.00.

OUTCOME

The proposed settlement will result in a dismissal of pending lawsuits challenging certain amendments to Title 16 made in 1999 and the legality of the assessment of table fees through FY 08/09.

BACKGROUND

On November 23, 1999, the San José City Council enacted Title 16 of the San José

Municipal Code entitled "Gaming Control." Title 16 replaced the former cardroom ordinance, Chapter 6.22 of the Municipal Code, under which the City had regulated cardroom operations with various amendments and revisions since the 1960s.

The California Gambling Control Act, enacted in 1997, required localities with existing cardrooms to have in effect by the end of 1999 an ordinance containing specific provisions addressing hours of operation, patron security and safety, the location of cardrooms, wagering limits, and the number of cardroom tables in each cardroom and in the jurisdiction. Without the ordinance, the State would deny State gambling licenses to the existing cardrooms, thereby ending legalized gambling in San José. The Council chose to allow cardrooms to continue to operate in San José by adopting Title 16, which contained the minimum requirements dictated by the Gambling Control Act, as well as changes recommended by a gaming consultant and other provisions directed by Council and the Administration.

The comprehensive system of regulatory controls that the City Council enacted in Title 16 is consistent with the requirements of State law. One provision of the Gambling Control Act, California Business and Professions Code section 19802, authorizes local government to prohibit or regulate gambling activities that are not prohibited or regulated by state law and to impose more stringent local controls or conditions upon cardrooms than are imposed by the Act.

The Litigation

Title 16 contains two provisions that have been the subject of complex ongoing litigation with the cardrooms, involving multiple lawsuits and a lengthy administrative process. The first provision that is the subject of the cardrooms' legal challenges is Section 16.16.010, which prohibits gaming between the hours of 2 and 6 a.m. There was a "phase-in period" to August 31, 2001, before the closure provisions were to go into effect. San José's cardrooms had continuous 24-hour gaming operations when Section 16.16.010 was adopted, so the eventual effect of the provision was to be a new four-hour closure of the gaming operations.

The second provision is Section 16.18.070 which eliminated "back line" betting, a method of betting that is used throughout the state as part of certain games referred to as "California" games. This form of betting allows players at the table and unseated players to place bets on other players' bets. This provision also was subject to a "phase-in period" until August 31, 2001. Section 16.18.080 provided for an extension of the phase-in period if necessary to avoid undue hardship.

In August 2001, the cardrooms each filed and began pursuing hardship petitions claiming that they were unable to comply with Sections 16.16.010 and 16.18.070 without experiencing severe financial impacts to their businesses. Pursuant to the provisions of Title 16, and following a lengthy legal discovery period, hearings on these hardship applications took place before the Hearing Officer, Retired Santa Clara County

Superior Court Judge Reed Ambler. In July 2002, Ret'd. Judge Ambler issued a decision relative to the Bay 101 application, in which he found that Bay 101 had failed to meet the threshold test for a finding of hardship, i.e., to use the 18-month period prior to filing the hardship petition to attempt to operate with the new provisions. He also indicated in the decision that he had concluded that there was not adequate evidence to support Bay 101's position that it would go out of business or suffer severe financial impacts if the provisions of Title 16 went into effect. He issued a similar decision as to Garden City.

Bay 101 sought a stay of this decision from the Superior Court so that it could file a legal challenge. Before it was able to obtain the stay, it had to operate for approximately two weeks with the challenged provisions in effect. Bay 101 closed its gaming operation between 2 and 6 a.m., and backline betting was not allowed. Bay 101 filed for bankruptcy prior to obtaining the stay. Because the Hearing Officer's decision relative to Garden City was not issued until August 13, 2002, Garden City did not operate under the disputed provisions during this time. When the Garden City decision was issued, the City stipulated to the same stay obtained by Bay 101. The stays are still in effect.

Pursuant to a court order, a second administrative hearing occurred before Ret'd. Judge Ambler to consider evidence of the economic impacts on Bay 101, while complying with the disputed provisions for two weeks, relative to the hardship applications of the cardrooms. That hearing was concluded in 2005, and resulted in the issuance of a decision as to each cardroom consistent with the initial decisions finding that the hardship petitions failed because each cardroom had not attempted to phase-in the reduced hours of operation and to eliminate backline betting. However, the Hearing Officer also found that there was clear and convincing evidence that the disputed Title 16 provisions had substantial financial impacts on Bay 101, and would have the same effects on Garden City, if implemented. The cardrooms have claimed in the litigation that this finding by Ret'd. Judge Ambler supports a "takings" claim against the City.

The cardrooms have filed several legal challenges to the enactment of the hours of operation limitation in Title 16, as well as the backline betting provisions. They have also challenged the administrative hearing process, claiming among other things that the requirement that they had to pay the costs of that hearing, including all of the City's costs, was a violation of constitutional due process.

In addition to the various challenges to the hours of operation, backline betting and hardship provisions of Title 16, the cardrooms have also filed lawsuits challenging the table fees that have been assessed over the past several years. The cardrooms pay an annual gross receipts tax of 13%. In addition to this tax, which goes to the general fund, the cardrooms each pay an annual assessment for the costs of gaming administration by the City. The assessment is made on each table in the establishments and is referred to as the "table fees." These fees have risen sharply over the past few years, reflecting the City's efforts to better identify and recoup the costs of gaming oversight,

regulation and enforcement. In April 2002, the City hired a Gaming Administrator who has brought a more active approach to gaming regulation in San José. The cardrooms are challenging the table fee assessments as being an illegal tax, and are claiming that the fees are excessive and not reasonably related to the costs of gaming administration.

The lawsuits that are the subject of this proposed settlement are:

- *Sutter's Place, Inc., dba Bay 101 v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-02-CV-810068
- *Sutter's Place, Inc., dba Bay101 v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-02-CV-812404
- *Frederick S. Wyle, as Trustee of Garden City, Inc., v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-02-CV-795974
- *Frederick S. Wyle, as Trustee of Garden City, Inc., v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-02-CV-810548
- *Sutter's Place, Inc., dba Bay 101 v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-06-CV-065644
- *Garden City, Inc. v. City of San José, et al.*, Santa Clara Superior Court Case No. 1-06-CV-068034

The Settlement

Following the second administrative hearing, during a time when certain issues in the ongoing litigation were on appeal and the cardrooms were each emerging from bankruptcy, the parties began mediation efforts with Retired Justice Edward Panelli. Lengthy negotiations ensued, with the City and the cardrooms exploring various methods of resolving the litigation.

The City's interests in a negotiated settlement included avoiding the risks of litigation, including potential damages and attorneys' fees claims if the cardrooms were successful in establishing that the challenged provisions of Title 16, if enforced, would result in a "taking" of their businesses. The City was very interested in developing and enacting an enforcement process for minor violations of Title 16, and in obtaining funding for social programs to assist in addressing perceived and real community impacts from gaming. The City also was interested in obtaining a dismissal of the table fees litigation, with an opportunity to review how the fees are assessed and options to ensure that the work of the Gaming Administrator is adequately funded and that the costs of cardroom regulation are recovered. Lastly, the City was interested in changes to Title 16 that would allow for more effective regulation.

The City understood that the cardrooms' interests in the negotiations included continuing backline betting in their establishments and 24-hour gaming operations, based on their allegations that both of these provisions were necessary to the financial viability of their businesses. They had argued in the administrative proceedings that the

four-hour closure, which was adopted in 1999 in part to address concerns about problem gamblers, did not have that effect. An alternative was developed that would prohibit individuals from patronizing the cardrooms for more than 20 consecutive hours without a four-hour break away from the cardrooms. This change is a way to provide a "cooling off period" in a manner that is focused on individuals. Finally, because both of the cardrooms are located on leased land, the City understood that they were interested in a change to Section 16.30.050 which allowed relocation only if the City were to commence a condemnation action.

ANALYSIS

The proposed settlement has several components. The proposed amendments to Title 16 reflect a number of changes that the City has wanted to make for several years to address issues that have arisen in connection with the application and enforcement of Title 16. The amendments include greater regulatory oversight of independent contractors, vendors, third party proposition players and funding sources. Provisions to streamline certain enforcement procedures, license and permit renewals, and the issuance of temporary licenses and permits are also included.

The proposed Title 16 changes that would allow backline betting reflect the Gaming Administrator's confidence that the revised provisions of the Municipal Code, along with regulations that he has and can promulgate, provide him with the tools necessary to ensure adequate and appropriate regulation of the games generally and backline betting in particular. These provisions include a prohibition on the "stacking" of bets, and the use of cameras to monitor operations to help ensure a fair and safe gaming environment. The proposed change from a four-hour nightly closure to a prohibition against individuals patronizing the cardrooms for more than 20 hours at a time, addresses the public policy concerns underlying the closure, yet allows the cardrooms to avoid what they assert is certain insolvency stemming from a closure or the elimination of backline betting.

The settlement eliminates the risks of the subject litigation, including the significant claims for damages and fees sought by the cardrooms in connection with the adoption of the two disputed provisions of Title 16. A settlement has real value to the City, in part because a judgment against the City would be paid out of the general fund, and in part because the gross receipts tax on the cardrooms represents in excess of \$10 million per year to the general fund. Continuing the litigation also involves substantial expenses, such as expert fees, and demands on staff resources both in the Attorney's and Gaming Administrator's offices, as well as other departments. Additionally, the cardrooms provide employment for hundreds of people in the City.

The proposed changes to Title 20 to allow relocation of the cardrooms pursuant to certain zoning and other land use restrictions attempt to balance the cardrooms' interests in the option to relocate and the City's interest in strictly regulating the location of cardrooms in the City. The existing language in Title 16 precluding relocation except

in the context of a condemnation action was potentially subject to legal challenge. The referral of the proposed Title 20 changes to the Planning Commission for consideration follows the City's process for review of potential zoning code revisions.

The settlement agreement also provides for the payment by the cardrooms of \$500,000 each for three years, FYs 09/10 through 11/12, to charitable organizations identified through the Council's Healthy Neighborhoods Committee, (or successor or similar committee of the Council) that address some of the social problems associated with gambling. The payments are to be made by the cardrooms directly to the organizations identified by the City. After FY 11/12, the amount of the required contribution decreases to a percentage of the current cardroom EBITDA (an accounting term referring to earnings before interest, taxes, depreciation, and amortization) that represents half of the \$500,000 or approximately \$250,000 for each cardroom. Because that amount is tied to EBITDA, the amount can fluctuate annually depending on the cardroom's revenues and profitability, among other accounting considerations. Minimally, the cardrooms each will be required to contribute \$125,000 if the specified percentage of EBITDA is less than that amount in any given year.

In exchange for a dismissal of the table fees cases, the City will agree to assess the table fees for this fiscal year at the same amount as last year, \$24,482. In addition, the City will review the process of estimating and assessing the costs to the City of gaming regulation and oversight, and will study various methods of cost recovery including direct fees for specific services such as licensing and permitting. The City will also provide information to the cardrooms on an annual basis showing how the fees were spent.

The proposed settlements provide that the parties will each be responsible for their own costs of litigation. The cardrooms are waiving all claims to recover the costs incurred in the administrative process and all other damages claims.

PUBLIC OUTREACH/INTEREST

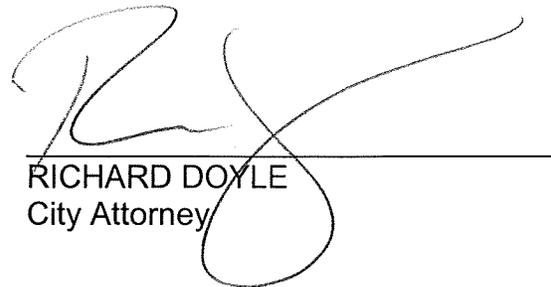
This memorandum, settlement agreements, proposed ordinances and resolution will be posted on the City's website for the March 24, 2009, agenda. This memo was included in the Early Distribution Council packet.

COORDINATION

This settlement has been coordinated with the City Manager's Office, the Police Department, the Finance Department, Planning, Building and Code Enforcement, and the Gaming Administrator.

CEQA

Not a Project.



RICHARD DOYLE
City Attorney

cc: Debra Figone, City Manager

For questions please contact RICHARD DOYLE, City Attorney, at (408) 535-1900