

A PRACTICAL
GUIDE FOR
OFFERING **ONLINE**
CONTESTS AND
PROMOTIONS



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Introduction

The internet has become one of the most efficient mediums for operators to disseminate online gaming, sweepstakes, and contests to participants worldwide. Opposing moral viewpoints, conflicting statutory interpretations and legal challenges have emerged in response to the unbridled growth of these online activities in the United States (U.S.). This guide outlines and discusses the types of online activities that can be lawfully offered over the internet to U.S. users.

Overview of the U.S. Gambling Prohibitions

The U.S. operates under a dual-sovereign system with both federal and state governance. Under this framework, the U.S. Constitution and federal law are the supreme law of the land and thus generally circumscribe the laws in the 50 U.S. states. The federal government, however, has not traditionally played a major role in the regulation of gaming. Instead, gaming regulation has been viewed as most appropriate for state and local jurisdictions with enforcement responsibilities primarily left to the individual states.

With the notable exception of laws governing sports wagering^{1,1} federal criminal law serves to assist individual states in enforcing state gambling laws by giving concurrent jurisdiction to federal law enforcement to police and prosecute multi-state and international gambling operations. Most federal restrictions, therefore, merely prohibit offering gambling activities in states where such activities are illegal under state law.

State gambling violations can take several forms, including lotteries, unlawful wagering and bookmaking. Pay-for-play games of chance with attendant prizes represent the most prevalent state gambling violation. Illegal games of chance fall under lottery laws that prohibit any activities where the following elements are present: a person (1) pays consideration—usually cash—directly or indirectly, (2) for the opportunity to win a prize, (3) as the result of a chance-based activity. If any of these three elements is missing, then the activity is generally, but not always, permitted under both state and federal law. Nevertheless, as the discussion below illustrates, analysis of these three elements is not consistent in all jurisdictions.

¹ The Federal Wire Wager Act, 18 U.S.C. § 1084, and the Professional and Amateur Sports Protection Act, 28 U.S.C. §§ 3701-3704.

Removal of Consideration

Removing the element of consideration from a prohibited gambling activity generally creates a lawful activity within the U.S. The resulting activity is referred to as a sweepstakes. A sweepstakes always contains the elements of chance and the award of a prize, but the element of consideration is absent to avoid violating various state or federal lottery prohibitions.

States typically fall into one of three general categories when evaluating whether the element of consideration is satisfied:

- pecuniary/economic value jurisdictions,
- traditional contract principals jurisdictions, and
- any consideration jurisdictions.

Most states follow a pecuniary/economic value analysis as it relates to consideration. Only a small number of states use the other two tests. The rationale under the pecuniary/economic value analysis is that consideration requires some measurable economic value flowing from the participant to the promoter, usually the transfer of money. A promotion that requires participants to buy a product or pay a monetary amount to participate in the promotion presents a clear example of consideration. Generally, the participant does not provide consideration where some nominal amount is paid to a third party, such as the cost of postage or fees for internet service, to enter a sweepstakes. But disguising entry fees as telephone or text message charges that accrue to the benefit of the sweepstakes promoter may be problematic.

A less clear situation arises when a promotion requires participants to expend some degree of effort that ultimately benefits the promoter (e.g., completing a questionnaire on consumer demographics or product preference). Unfortunately, neither federal nor state law specifies how much effort the consumer must expend before the activity is deemed consideration. Generally, the more effort required, the greater the likelihood it will be deemed consideration.

Two methods of removing consideration are common. Under the first method, the operator does not charge any participants to enter the sweepstakes. Here, an operator's revenues are derived from the increased sales of goods created by the advertising value of the sweepstakes or collecting fees from third parties, such as sweepstakes sponsors.

A permanent sweepstakes website where the prizes for the chance-based games are provided by sponsors who advertise on the site are common on the internet. The underlying idea behind these sites is that the sweepstakes will help build a sponsor's brand. The sweepstakes can be a traditional raffle or an instant-win promotion but also can extend to any game of chance, including casino-style gaming. Caution should be exercised, as a state may have restrictions on the number or type of promotional sweepstakes that a promoter may offer.

A second sweepstakes model allows participants to enter by paying indirect consideration through the purchase of a good or service while providing a free alternative method for anyone to enter the promotion. A common example is a promotion at a fast food restaurant, where participants receive game pieces in exchange for purchasing hamburgers or soft drinks. These game pieces, either by themselves or in combination, provide an opportunity for the purchaser to win valuable prizes in lottery-type games. The key feature of this type of promotion distinguishing it from illegal gambling is the alternative opportunity to participate without having to purchase anything.

This second sweepstakes model is commonly referred to as having a free Alternative Method of Entry (AMOE). AMOEs are common in every state, even though most participants enter the sweepstakes by purchasing the product being promoted. Common examples of popular AMOEs include distribution at point-of-purchase, mail-in entries, or entries through a toll-free telephone number.

Most state sweepstakes laws require operators to disclose the no purchase method of entry in a clear and conspicuous manner. Often the phrases “no purchase necessary” and “purchase will not increase your chances of winning” are displayed prominently on the online sweepstakes site and all accompanying sweepstakes materials.

The AMOE also must have “equal dignity” with the purchase method of entry. This means that non-paying participants must have an equal opportunity to enter and win the sweepstakes. They should not face lesser odds or greater obstacles and should have an equal chance to win any of the prizes offered. For example, a person who enters by paying consideration cannot receive a disproportionate number of entries compared to a non-paying participant. Moreover, paying customers cannot have the opportunity to win different or more expensive prizes. Any material disparity (actual or perceived) between paying and non-paying entrants can invalidate the AMOE and render the sweepstakes illegal.

Operators should be cautioned that the AMOE sweepstakes model cannot be implemented to merely disguise what in substance constitutes gambling. Higher scrutiny is applied to AMOE sweepstakes because operators may attempt to make money from paying customers desiring to win prizes, as opposed to promoting a product unrelated to the sweepstakes. This is a very real distinction in some courts and requires special legal caution and consideration.

Removal of Chance

Removing the element of chance is another common and effective way to ensure an activity is legal under current law. When the element of chance is removed, it generally creates a lawful skill game or contest.

Skill games have long been distinguished from games of chance. From carnival midways to bowling tournaments, the opportunity to win prizes based on the demonstration of skill has continually drawn the interest of the young and old alike. In recent years, the internet has exploded with hundreds of pay-for-play skill game sites. Leading games of this type are fantasy sports and casual games such as solitaire, checkers, Tetris, and other puzzle or strategy games. The genre of “hardcore” games, which require more complex interaction, skills and training by participants, is growing in popularity, especially among teenagers. These games include sports simulation, first-person shooter and role-playing games.

Whether a pay-for-play skill game for prizes is a permitted game as opposed to a prohibited game of chance is typically based on the relative degrees of skill and chance present in the game. Although varying by state, the tests used to analyze skill versus chance include:

- predominance test,
- material element test, and
- any chance test.

Most states use the predominance test. That is, if the element of skill in a particular game predominates over chance, then the game is permitted.

Several other states, however, prohibit a game if chance plays a material element in determining a win or loss. Some courts interpret the more subjective material element test as a lesser standard than the predominance test. The reason is that chance does not need to predominate in order for the game to be considered a game of chance. Hence, in states that apply the material element test, it may be difficult to offer skill based games that resort to a chance component in determining the outcome.

A few states adhere to the “any chance” test. This means that a game is considered chance-based if any element of chance affects the outcome. As virtually every game has some element of chance, most skill games will not survive scrutiny in these states.

Finally, some states simply prohibit pay-for-play skill games regardless of skill level, unless the game is specifically exempted by state law.

In any jurisdiction that distinguishes games of chance from skill contests, the determination as to whether a game is one of skill or chance is not a question of law, but one of fact. The operator would need to prove through expert witnesses or other evidence that the game's skill levels meet the requisite test in the applicable state. A judge or juror would then decide the outcome after reviewing the evidence (usually in the form of expert mathematical testimony). Apart from the merits of the games themselves, the ultimate results of any court case are determined by all of the facts presented to the court, including the quality of each side's evidence and experts and/ or the leanings of the judge or jury.

Types of Chance

When evaluating a contest on the basis of skill versus chance, it is important to know that there are several types of chance. The most common type is systemic chance. Systemic chance occurs where the game itself has random elements created either by a random number generator in a computer program or some other random event, such as a dice throw, ball draw, or card shuffle. In Scrabble, for example, systemic chance is the random selection of tiles. In poker, it is the shuffle and deal of the cards.

A second type of chance is imperfect knowledge or information. This phenomenon occurs where the outcome of a game is not solely determined by skill, but is also influenced by having incomplete information of all factors that can impact game results. This type of chance could occur even where the players have identical "draws," but otherwise have imperfect knowledge – particularly where they need to make decisions based on unexposed icons, symbols or an absence of information. Take, for example, the game of rock, paper and scissors. While the game does not have systemic chance, imperfect information is present since players need to make decisions based on the absence of information, e.g., each player must act simultaneously and thus acts without knowledge as to the other player's choice of rock, paper or scissors. This is in contrast to chess, where players move sequentially and have complete information regarding the factors that can impact outcome, e.g., after one's opponent moves in chess, the game board is instantaneously updated to allow a skilled response. If the unknown factors in the game are such that the imperfect information has an impact on who wins, there is a greater likelihood that the game will be considered one of chance.

Still other forms of chance may exist. One example is where a game is designed to negate skill by making the skill levels beyond the capabilities of the participants. For example, imagine administering a multiple-choice test on quantum physics to ordinary 8-year-olds. Would the test results be based on skill or chance? Likely, most 8-year-olds would simply resort to guessing at the correct answer.

Accordingly, when reviewing the skill levels of their games, operators should ask themselves the following questions:

- Does the game have defined rules without predetermined odds of success?
- Are there genuine skill elements whereby persons possessing the requisite skills have a consistent and decided advantage over non-skilled competitors?
- Does the format of the games allow the skilled competitor to exercise these traits?
- Is the competitor's skill the determining factor in the outcome of the game, as opposed to fortunate circumstances resulting in an easier game or draw?
- Does every stage of the game meet the requisite skill levels including tie breakers?
- Has the designer removed as many random events in the game as possible?
- Has or can the company develop sufficient evidence to support a position that the game meets the requisite skill levels under the tests described above?

Ultimately, an operator must be able to establish that their games satisfy the requisite skill levels in each state where they are offered.

Removal of Prize

If the elements of consideration and chance are present but the award of a prize is eliminated, then the activity will be legal in most, if not all, states. While many states do not define what constitutes a "prize" within their statutes and have no case law on the matter, prizes traditionally have been considered to be things such as money and tangible items. In recent years, non-traditional prizes have become increasingly popular. Non-traditional prizes include offering extended play, avatars, the accumulation of points or poker chips for bragging rights and similar items. No court has addressed whether awarding virtual chips or other virtual items to the winners of a game constitutes a prize. Two issues arise when considering whether something has value. The first is whether the item awarded has a market value. While non-cash prizes

such as cars or vacations are common, courts generally require prizes to have a reasonably determined value. Therefore, a difference exists between an honor and a prize (i.e., merely being crowned a champion or receiving an acknowledgment in the form of a virtual item versus receiving goods or services that have a defined market value). The same distinction could apply to a virtual item that has functional utility only in the game in which it is awarded. This could include the award of a virtual tractor that can only be used in a farm game. Accordingly, operators must avoid assigning a value to these virtual goods. The second issue is whether the item, despite having no market value, can be exchanged for cash or an item of value. An example would be tickets from arcade games that can be exchanged for prizes.

Operators should take precaution that the virtual objects awarded cannot be purchased, sold, or transferred in the game or via secondary markets outside the game. Secondary markets, even if operated by independent third parties, can create a reasonably determinable value for the items. Even in the absence of an operator's authorization or support, a prosecutor could argue that the company knowingly profits from the secondary market.

A key factor in the analysis of potential liability is an operator's efforts to stop the secondary markets. Companies need to be diligent and aggressive in eradicating such markets. An effective method to limit these secondary markets is to bind the virtual items to a player. If the virtual items are bound to the player, the ability to transfer or exchange the items is eradicated and, consequently, so is the secondary market. Eliminating a secondary market for these virtual items supports the argument that they are merely bragging rights with no market value.

Finally, operators need to understand the risks of awarding extended play without offering free play to potential participants. Some state laws provide that an extension of a service is something of value and, therefore, conforms to/satisfies the definition of a prize. The basis for prohibiting extended play stems from crafty entrepreneurs placing poker machines in bars that only accumulated additional credits, which ostensibly could be used only for additional plays. Ordinarily this would not pose a problem. Certain operators, however, instituted a procedure where players, when ready to leave the bar, would notify the bartender, who would verify the credits left on the machine, pay the player the remaining credits in equivalent cash, and "knock off" or remove the credits by a reset button or simply unplugging and replugging the machine, thereby resetting it for the next customer. In essence, this is gambling using hand pays.

Upon learning of these business ventures, legislatures subsequently passed laws specifying that extended play constitutes a prize. Consequently, in states that outlaw extended play, a game would likely be considered unlawful if players risk something of value (consideration), on the outcome of a game of chance, with the understanding that they will receive extended play (prize).

In short, a properly constructed virtual prize model should have few problems being defended. An award of such virtual objects should not be considered a prize (for the purposes of gambling law) if it is non-refundable and is not exchangeable, replaceable, redeemable, or transferable for any real-world funds or prizes. For example, if a player who wins virtual chips has absolutely no way to redeem them for cash, tangible objects, or other items of value during game play or via secondary markets outside the game, the items won have no independent market value, and therefore, do not constitute a prize for the purposes of gambling law.

Goals: Adequate Preparation to Avoid Legal Problems

Current laws offer opportunities for operators to disseminate their online games to citizens in the U.S. Nevertheless, those seeking to use the internet to conduct contests or sweepstakes must recognize they are entering an intricate and specialized industry. As such, existing and aspiring operators must understand and operate within these complex legal boundaries.

The goal is adequate preparation to avoid legal problems. Operators must comply with federal law and the laws of all the states where they accept participants. Complying with the laws where the company has its offices or houses its servers is insufficient. Accordingly, a 50-state review should be conducted to individually analyze the case law, statutes, attorney general opinions, and other available legal materials for each state in order to categorize the states by level of risk. Doing this will help an operator determine the states from which the site will accept participants and those from which it will not.

Finally, operators need to adopt a compliance program designed to prevent prohibited persons from utilizing the site. While no specific procedures are mandated, many sites have implemented several measures to meet the legal requirements. These include:

- geo-blocking software,
- address verification services,
- credit verification services,
- proof of government identification before issuing prizes.

Moreover, the program needs to be regularly audited and tested for exceptions. Maintaining established practices for immediately implementing new or remedying old procedures is advisable.

Conclusion

There are many opportunities for operators to develop business and build their brands with games and sweepstakes on the internet, but consideration must be given to the legal complexities of doing so. Gambling laws vary from state to state and operators would be wise to conduct thorough research on each before initiating contests, sweepstakes, or games in any given location.

Lewis Roca has one of the largest dedicated gaming law practices in the world. The attorneys in our practice group have extensive experience in gaming law that spans several decades, which includes experience in casino gaming (commercial and tribal), Internet gaming, sports betting, pari-mutuel racing, sweepstakes, lottery, bingo and compliance.

Our gaming practice group is nationally recognized across the industry and has been at the forefront of all major gaming developments for the past quarter century. We represent casino operators, gaming manufacturers and distributors, management companies, tribes, entrepreneurs, investors, and governments in a variety of matters including licensing, compliance, transactions, restructuring, and regulatory adoption.

As legalized gaming continues to proliferate across the United States and the world, the laws governing the gaming industry continue to evolve. Lewis Roca's gaming practice group closely monitors activity in this unique industry to provide our clients with sound and timely advice.