Gamblification

An Overview of Legal Issues with Gambling in Social Games and Social Media

The use of creative business models and strategies involving contests, sweepstakes and gambling-like activities in social games and other online media has increased dramatically. These "gamblification" strategies aim for a balance between capitalizing on users' excitement and passion for the mechanics inherent in gambling while not crossing the line into illegal activity. In some cases, the use of virtual currencies and goods causes greater confusion and misconceptions regarding legality.

Social game and mobile app developers and others in the social media industry are seeking to cash in on these powerful business opportunities. Companies in the gambling industry are focused on these opportunities as well. In January 2012, gambling equipment maker IGT bought Facebook casino games developer Double-Down for $500 million. As this trend continues, the $25 billion online gambling and social media worlds are colliding.

Gamblification: We have adopted this term to describe the intersection of social media and gambling, playing on the similar terminology and concept behind "gamification." Much as gamification involves the use of game mechanics for nongame purposes, gamblification is using gambling mechanics for non-gambling purposes.

The slowly evolving legal jurisprudence in this area is lagging behind the rapidly advancing use of gamblification. However, a recent decision by the U.S. Department of Justice (DOJ) has paved the way for states to craft legislation to permit most forms of online gaming. This catalyst has led to a frenzy of state legislative activity, with some states seeking to permit and some states expressly trying to prohibit various forms of online gambling.

Companies need to be aware of the complex legal issues and significant risks involved when gamblification techniques are not crafted and implemented properly. Criminal penalties exist for unlawful online gambling activities, as evidenced by the 2011 federal indictments against illegal online poker sites operating in the U.S. Even if a particular activity is legal, various licensing and compliance obligations may apply.

In December 2011, the DOJ reversed its position on the scope of the 1961 Wire Act. Previously, the DOJ maintained that the Wire Act prohibited most forms of online gambling. Now it interprets the Wire Act to primarily prohibit online sports betting. As a result, states are now free to legalize online gaming and many are seeking to do so. Other states, such as Utah, are expressly prohibiting it.

While land-based casinos and online gambling companies are familiar with these licensing and compliance issues, many social game and media companies are not.

The following overview covers some of the many legal issues involved with contests, sweepstakes and gambling in social games and other social media applications. Sheppard Mullin's Social Media and Games Team has assisted many companies in assessing business models, legal strategies and compliance programs in these areas. Please contact us if you have any questions.

Examples of Gamblification

Businesses are employing a wide range of contest, sweepstakes and gambling-like techniques to attract users and monetize applications. Examples include:

Casino-like Social Games
Zynga Poker, one of Zynga's most profitable social games, lets users buy virtual poker chips (but not redeem them) to play an online poker game.

Mini-games
Some social games incorporate mini-games in which, through skill and/or chance, players may obtain in-game items such as virtual goods, power-ups, virtual currency, etc.

Player-to-Player Wagering Platforms
Virgin Games and others provide platforms to enable gamers to wager against each other on the outcome of game play.

Tournaments
Many companies have created platforms to host gaming tournaments in which users pay a fee, in real or virtual currency, to compete and win prizes.

Virtual Currency Sweepstakes
Some sites reward certain user activity with a form of virtual currency that can be used to enter contests or sweepstakes to win virtual or real goods.

Marketing and Customer Acquisition
Cash Dazzle and other sites offer users a spin of a cash prize wheel in exchange for participating in sponsors' offers.

Fantasy Sports Leagues
Many fantasy sports platforms run the duration of a sports season. Some more recent offerings are based on single games or even single games or even single plays, and come closer to the line of sports betting.

Overview of Select Legal Issues

State Law - For the most part, these activities involve two major legal issues – legality and compliance. Whether an activity is legal is largely governed by state law. In some cases, the laws are written to address contests, sweepstakes, and lotteries. But not all illegal lotteries are gambling. Some states have specific anti-gambling laws. Many of these laws were written long before the rise of the Internet, much less the proliferation of social games and virtual currency. There is a dearth of legal precedent in some states. Some state Attorney General's opinions exist, but the AGs in some states have flip-flopped on their position. Many states are now crafting specific legislation to address online gambling.

Federal Law - Until a recent DOJ memo, the Wire Act was interpreted to prohibit states from enacting certain legislation involving online gambling. Now the Act is seen as primarily prohibiting sports betting. Other federal statutes facilitate enforcement against activities that violate state gambling and illegal lottery laws. Federal agencies with jurisdiction include DOJ, the U.S. Postal Service, Federal Communications Commission and Federal Trade Commission.

The disparity in state laws makes determining legality and ensuring compliance complex. Many states laws include similar terms to define these activities, such as "prize," "chance" and "consideration," but the meaning of and test for these terms can vary widely from state to state (and under federal law). Assuming an activity is legal, different states have different compliance requirements.

Overview of State Law Issues

Elements of Gambling
Most states regulate these activities by prohibiting illegal lotteries. In states where lotteries are legal, they typically authorize state-run lotteries, but prohibit private-sector lotteries. In most states, an illegal lottery or gambling involves three elements:

1. Payment of some form of consideration

2. Result determined by chance and not skill

3. Prize

In general, if all three of these elements are present, that offering may be an illegal lottery and may be gambling. If any of these elements is removed, the offering will generally fall outside the anti-lottery/gambling laws. If payment of consideration by the user is eliminated, then the result is typically a sweepstakes. If chance is eliminated, the activity can be a skill-based contest. While these three elements seem to be fairly simple terms, their interpretation is not. Their meaning varies from state to state, as detailed below, and under federal law.

Not all illegal lotteries constitute illegal gambling. Gambling typically involves making a wager or a bet. Congress has defined "bet or wager" to include staking or risking something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome. Congress excluded the following from this definition: participation in any game or contest in which participants do not stake or risk anything of value other than (i) personal efforts of the participants in playing the game or contest or obtaining access to the Internet; or (ii) points or credits that the sponsor of the game or contest provides to participants free of charge and that can be used or redeemed only for participation in games or contests offered by the sponsor.

In the traditional scenario, consideration would involve a user paying money to participate in an activity (e.g., a raffle) and receiving a chance (e.g., random drawing) to win a cash prize or valuable tangible goods (e.g, a car). In this situation it is easy to see that consideration and chance are present and that there is a prize or award having real value.

But when virtual goods or currencies are used, determining if there is a payment or prize can be more complicated. A challenge for many lawyers, including traditional gambling counsel, is the lack of a detailed understanding of virtual goods and virtual currency business models. Some categorically think that because they are "virtual," these items never have value. When leveraging contests, sweepstakes and other gamblification techniques in social games and online media, a thorough understanding of legal and regulatory issues of virtual goods and currency is critical. For more information, see our **Overview of Legal Issues with Virtual Currency** (found at www.virtualworldlaw.com).

Consideration – This usually means a player must pay something of "value" to be eligible to participate. A payment of cash for the activity itself most always will constitute consideration. However, if a player pays to acquire something of value and also gets a chance to win something, particularly if there is an alternative means of entry that does not require a purchase, then this cash "payment" may not be deemed to be consideration. But many states take a much broader view of what constitutes payment of value. In some cases, states have found that consideration may exist if participants are required to expend substantial time or effort to participate. Under federal law, Congress has expressly excluded payments for Internet access and certain types of virtual currency from gambling regulation.

Chance – The meaning of this element varies widely. In some states this element is satisfied if the outcome is determined by any element of chance. In other states, the test involves whether chance or skill predominates. This is perhaps one of the most complex elements to assess. Some legislators and regulators view poker as a game of chance. Professional poker players vehemently disagree. Courts sometimes consider other factors such as whether the activity involves playing one hand of poker or a longer duration of play (e.g., a multi-table tournament). MMO and video game players would argue that their game play requires skill. But some mini-games or individual game features may involve chance. If a user purchases an in-game weapon that may give the user a better "chance" to accomplish a goal (e.g., slay an in-game monster) and gain more virtual currency or other virtual goods as a result, is that "chance" under the various state laws or is it just part of game play?

Prize or Award – Something of value that a player wins. Prizes can include money and valuable physical goods (e.g., a car or iPad), but can also include something else of value.

The Impact of Virtual Items on the Legal Analysis

The increasing use of virtual goods and currency in social games and other online gamblification scenarios make these determinations more difficult. For example, if an online game player puts up virtual currency for a chance to win virtual goods, has he/she paid consideration and/or received value? The answer may depend in part on whether the virtual currency and/or virtual goods have "value." This is a seemingly simple inquiry, but in reality the answer is not always so simple. The analysis of whether virtual items have value may depend on:

- how the player acquired the virtual currency (e.g., whether it was paid for with real cash or earned through game play);
- what the player can do with the virtual currency (e.g., cash it out for real money or real-world goods, or just use it in a game to acquire virtual goods, which themselves may or may not have extrinsic value); and
- with whom can it be used (e.g., the virtual currency issuer or third parties).

Some social games and apps include "dual currency" models, which permit buying one form of virtual currency which may be used only for certain transactions, but earning another form of virtual currency for use in other transactions.

Further complicating the analysis can be the use of dual currency models and/or whether secondary markets exist for the virtual items. In their terms of service, most social games and social media applications prohibit players from selling or trading virtual goods, virtual currencies, or player accounts. Nonetheless, there are a number of unauthorized secondary markets that enable players to do so. To the extent that these markets exist and involve real money purchases, this may be relevant to the determination of whether the virtual goods or currency have value.

Summary of Potentially Relevant Federal Laws

The 1961 Wire Act – Has applicability to online gambling by prohibiting use of most interstate telecommunications mediums for transmitting bets or wagers, or information assisting in placing bets or wagers, on any sporting event or contest. It had been interpreted to prohibit all forms of gambling across state lines or the transfer of gambling-related funds between states or in and out of the country. However, in December 2011, the Department of Justice issued a memo that declared that the scope of the Wire Act is limited to sports betting.

The Unlawful Internet Gambling Enforcement Act ("UIGEA") – Enacted in 2006, this is primarily an enforcement statute. It forbids financial institutions from processing payments associated with gambling sites, but excludes certain activities relating to online lotteries, fantasy sports and horse racing. Section 5363 contains criminal prohibitions and provides that no person engaged in the business of betting or wagering may knowingly accept most payments including credit, the proceeds of credit, credit card payments, electronic fund transfers or the proceeds from EFTs, checks, drafts or similar instruments, or the proceeds from any other financial transaction from a player in connection with unlawful Internet gambling. The act itself does not precisely define what constitutes unlawful gambling, but instead generally refers to activities that are deemed illegal gambling under federal or state law.

Online and mobile payment processors need to ensure that they are not unwittingly processing unlawful transactions.

The Professional & Amateur Sports Protection Act – Makes it unlawful for: (1) a government entity to sponsor, operate, advertise, promote, license, or authorize by law or compact, or (2) a person to sponsor, operate, advertise, or promote, pursuant to the law or compact of a governmental entity, a lottery, sweepstakes, or other betting, gambling, or wagering scheme based, directly or indirectly (through the use of geographical references or otherwise), on one or more competitive games in which amateur or professional athletes participate, or are intended to participate, or on one or more performances of such athletes in such games. Because some states (Nevada, Oregon, Delaware and Montana) already had state-authorized sports wagering, statutory exceptions allow them to continue.

The Travel Act and The Illegal Gambling Business Act – Both are primarily enforcement statutes and require a finding of a violation of a state law as a predicate to their applicability. The Travel Act prohibits using any facility in interstate or foreign commerce with the intent to promote, manage, establish, carry on or facilitate unlawful activity. The Illegal Gambling Business Act prohibits financing, owning or operating an illegal gambling business.

Regulatory Compliance

Even if an activity is permissible online gambling within a particular state, various licensing and other compliance steps still may be necessary. The thrust of many compliance provisions is to protect against defrauding of consumers through rigged gambling mechanisms and to prevent money laundering and other financial crimes. Assuming an activity does not constitute illegal gambling, certain regulatory compliance issues may still apply. For example, if an activity is a skill-based contest or sweepstakes, some state laws may require registration of the contest, filing of a bond to cover any prize amount, specific written and posted rules for the contest or promotion and maintenance of records regarding winners, among other things.

Other Legal Issues to Consider

- **Social Platforms and App Stores –** As social networking sites and app stores are becoming the delivery method of choice for social games and applications, companies need to develop their gamblification strategies with these platforms in mind. Some of these services preclude certain gambling-related activities. Ensuring conformity with these distribution models from the outset can save time, effort and money.

- **Intellectual Property –** New business models and technologies are created by pioneers and innovators. Then they are copied by others. In developing industries, intellectual property issues are highly relevant. However, many companies do not fully understand or have misconceptions about these issues. Working with IP counsel that understands virtual currency and gamblification is a must. For additional information, please see our piece, "IP Protection for Games."

- **Terms of Use –** Many social game companies are aware of the importance of well-crafted terms of use. Additional considerations are relevant when leveraging gamblification, and particularly when virtual goods or virtual currency is involved.

- **Policing Secondary Markets –** To the extent that secondary markets may affect whether a particular gamblification implementation using virtual items involves "value," understanding when and how to police and take action against these markets may be important.

- **International Laws –** The foregoing focuses primarily on U.S. law. Most social games are available internationally. Many countries have their own laws that must be considered as well.

Industry Involvement

Our unique capability to provide comprehensive, proactive advice on these cutting-edge issues results, in part, from our attorneys' commitment to be involved in and stay abreast of rapidly evolving business, legal and technical trends. Through this involvement, our team obtains valuable knowledge and insights that enable us to provide significant strategic advice and resources to clients, well beyond just "doing legal work."

How Sheppard Mullin's Social Media Team and Games Team Can Help

Our team can:

- Analyze your virtual goods/virtual currency business model to help you avoid legal pitfalls

- Draft a solid terms of service agreement—with a focus on your virtual goods and virtual currency models to minimize user issues and liability

- Develop and implement IP strategies to protect your virtual goods/currencies

- Monitor and enforce unauthorized uses, including secondary markets

- Draft privacy, COPPA, DMCA and data protection/storage policies

About Sheppard Mullin

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