

How the Evolution of Games Has Led to a Rise in Gambling Concerns: All Bets are On! Gambling and Video Games

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Recently, there has been a frenzy of legal activity with U.S. gambling laws and the number of gambling-related legal issues with video games. U.S. gambling laws have changed more in the past few years than they have in a long time. Significant state law changes have occurred concerning online gambling, sports betting, fantasy sports, and skilled-based games, to name a few. Some significant recent changes under federal gambling law have also occurred. The evolution of certain aspects of games by the game industry— particularly those involving loot boxes, casino-style games, and chance-based mechanics with virtual items— has raised the perception of certain gambling-related issues. Despite being prohibited by game publishers, players' engagement in unauthorized activities (e.g., selling virtual items on secondary markets and "skin gambling") have exacerbated these issues. The financial success of these monetization techniques has led to greater legal scrutiny. The rise of eSports has also implicated sport betting issues.

The gambling-related legal issues with video games are still being resolved. A significant debate is occurring. Some argue the game industry is so profitable because it delivers a compelling entertainment experience to a broad demographic of people who are willing to pay for that entertainment. Others claim games have become addictive and include elements that constitute gambling. This paper will not

resolve that debate. However, it will:

- provide an overview of US gambling laws;
- address significant, recent changes in US gambling laws;
- identify factors that have led to the rise in gambling issues with video games; •
- summarize recent enforcement activity involving games; and
- provide some perspective on what may lay ahead.

Overview of Gambling Laws in the US and Recent Changes

Gambling is regulated in the United States via federal and state laws. With few exceptions, most of the substantive laws defining gambling are state laws. Most states' laws prohibit illegal lotteries and separately prohibit illegal gambling. In states where lotteries are legal, they typically authorize state-run lotteries, but prohibit private-sector lotteries. In most states, an illegal lottery involves three elements:

1. Payment of some form of consideration
2. A result determined by chance and not skill
3. A prize

This is often referred to as the prize-chance-consideration test.

In general, if all three of these elements are present, that offering may be an illegal lottery and may also constitute illegal gambling. If at least one 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.

Many states gambling statutes include factors similar to the prize-chance-consideration test for lotteries. However, the gambling laws can and do differ from the lottery laws. Many gambling statutes require something more than just any form of consideration. Gambling typically requires making a "bet or wager." Details on what constitutes a bet or wager are provided below. A number of courts have ruled that not every payment for a chance to win a prize is a bet or wager.¹ This is a commonly misunderstood issue. As detailed below, this can be significant to games where players pay to buy virtual items. Paying for goods or services is typically not a bet or wager, but rather a bona fide commercial transaction. Many states expressly exempt from their gambling laws bona fide business transactions enforceable under the law of contracts.

One important requirement under most states' gambling laws is that the thing "bet or wagered" and the prize or thing won must be a "thing of value." Money and tangible property are often things of value. But when virtual items (e.g., virtual currency or virtual casino chips) are at issue, the analysis is not always so easy. For example, if an online game player puts up virtual currency for a chance to win virtual items which cannot be cashed out, has he or she staked a thing of value and/or won a prize that is a thing of value? This question is central to a number of ongoing legal disputes involving the question of whether certain games involve gambling. Secondary markets (often unauthorized) can complicate the analysis. These issues

will be addressed in detail below.<2>

Historically, some of the most important federal gambling laws are those provided immediately below. Other federal gambling statutes are primarily enforcement statutes and do not define what constitutes gambling.³

- The Unlawful Internet Gambling Enforcement Act (“UIGEA”) – The last new federal gambling legislation, enacted in 2006, UIGEA is primarily an enforcement statute. It forbids financial institutions from processing payments associated with certain illegal gambling activity. The act itself does not define what constitutes unlawful gambling, but instead generally refers to activities that are deemed illegal gambling under other federal or state law.

Federal gambling law remained static after the enactment of UIGEA until two important changes occurred. The first was the reinterpretation of the Wire Act. The second was the declaration of PASPA as being unconstitutional.

- The 1961 Wire Act (“Wire Act”) – Until 2011, this law prohibited 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. This had been interpreted to prohibit all forms of gambling across state lines (i.e., sports events and any other contests). However, in December 2011, the Department of Justice (DOJ) issued a memo that declared that the scope of the Wire Act is limited to sports betting. As a result, states became free to legalize online gambling (other than sports betting). A number of states have done so and others are in the process of doing so.

- The Professional & Amateur Sports Protection Act (PASPA) – Until the Supreme Court struck down PASPA as unconstitutional, it prohibited most sports betting.⁴ The Supreme Court’s declaration that PASPA is unconstitutional paves the way for states to legalize intrastate sports betting.⁵ However, due to the Wire Act, most interstate sports betting is still illegal.

State gambling laws have changed at a more rapid pace. The following is an overview of some areas where state gambling have recently changed.

- FANTASY SPORTS – For many years, season long fantasy sports leagues thrived. With limited exceptions, the legality of fantasy sports was not challenged. Over the past few year, some fantasy sports upstarts evolved the business model from season-long to daily fantasy sports (DFS). The advent of DFS, coupled with the aggressive marketing and huge prizes offered by some of the industry leaders, led to a flurry of legal activity. This activity included enforcement actions by the New York Attorney General and others. The end game is still playing out, but a number of states have passed legislation to legalize DFS, subject to licenses, taxes, and other conditions. Other states have banned DFS through legislation or AG opinions. Some states have not yet acted. This has lead to a patchwork of regulation, requiring fantasy sports operators to exclude players from a number of states.

- ONLINE GAMBLING – In response to the DOJ memo on the Wire Act, a number of states passed legislation authorizing certain online gambling activity.

- **SPORTS BETTING** – The sports betting market in the U.S. is estimated by some to be a \$100 billion market. Much of that represents illegal sports betting. Despite the huge appetite of U.S. sports bettors, most sports betting had been illegal in the U.S. due to PASPA. As a result of the demise of PASPA, there has been a flurry of state legislative activity related to sports betting. In anticipation of this decision, a number of states passed laws favorable to sports betting, conditioned on PASPA being struck down. Other states moved promptly after PASPA was struck down. Other states have currently pending sports betting legislation.
- **ESPORTS BETTING** – eSports has been a huge growth driver for the video game industry. Many debate whether eSports is actually a sport, but in many ways it is being treated as such. For example, international competitors are obtaining visas based on classification as professional athletes. One implication of this is that if eSports is a sport, wagering on it is likely sports betting. Those looking to offer eSports betting likely will benefit from the favorable changes to the sports betting laws described above. However, just because PASPA was struck down does not mean that esports betting is legal under state law. Legislative action and licensing will likely be required on a state-by-state basis. In addition to the general sports betting laws being passed, some states have or likely will specifically legalize eSports betting. Nevada was one of the first to pass an eSports-specific betting law.
- **SKILL-BASED GAMES** – Due to the changing demographics and the challenges that land-based casinos have faced in attracting millennials to their facilities, casino operators have advocated for the legalization of skill-based games. This covers a range of activities including integrating skill-based games with games of chance, such that a player increases their chance of winning based on their own skill. This enables video games and other skill-based activity to be incorporated into casino games. Companies like Gameco have emerged as leaders in the commercialization of this activity.

How the Evolution of the Video Game Industry has Led to a Rise in Gambling Concerns

While the gambling laws have been changing, the video game industry has been evolving as well. Of course, the video game industry has evolved since its inception. But the pace of evolution seems to be accelerating. This evolution includes changes to the business model.

Video games started in arcades, where players dropped coins into a machine to play. With the advent of home-based game consoles, players purchased a game console and prepackaged game cartridges. These games typically comprised “fixed” content. If a new version of the game was created, players would have to buy a new cartridge.

As video games have evolved, the content has become more dynamic. With online games, the content could be changed on the server so the game could be continually updated. For some games, players paid a subscription fee. As games continued to evolve, free-to-play games and downloadable content became prominent. Many games could be played for free, but players could buy content to be downloaded into the game. Instead of selling games, publishers made money by selling virtual goods and virtual currency. Players could obtain certain virtual items through in-game

achievements or buying them. To make the acquisition of virtual items more interesting, loot boxes and other chance-based mechanics were included to give players the perception of winning certain items. In other games, such as massively multiplayer online games (or MMOs) and other strategy games, various chance-based mechanics and mini-casino games have become very popular.

Social casino games also became popular. Some of the top grossing mobile games include ones that are based on simulated, gambling activities, such as poker, slot machines and other casino-style game mechanics, but with an important limitation. Players could play for fun, but could not cash out any virtual chips that they won. eSports has given rise to games as a spectator sport. Esports tournaments with huge prizes and millions of viewers created a new channel for the game industry.

Lastly, the rise of blockchain technology has led to a genre of games referred to as blockchain-based games. This genre of games is still in its infancy, but some games have virtual items that have sold for \$100,000.

In addition to the monetization techniques that the game industry has adopted, a variety of unauthorized monetization has occurred as well. This unauthorized monetization includes skin gambling (which typically happens outside of the game in which the skins are used) and the selling of virtual items on secondary markets (i.e., markets not controlled or authorized by the game provider). The terms of service for most games that use virtual items 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. However, recent cases have found that they do not, at least where the game publisher does not run the market.

These evolutionary changes in the games industry have raised a number of gambling-related issues. Various factors have contributed to this. One significant factor is the change in how games are monetized through virtual items coupled with chance-based activities by which users can “win” virtual items. Another factor is the popularity of casino-style games. These game mechanics and games are intended to be for entertainment purposes only. Nearly all expressly prohibit any ability for players to cash out their virtual items for money or anything else of value. Yet, many games have been targeted for allegedly involving gambling. The next section will address some of the recent legal activity.

Recent Enforcement Activity Involving Games

Most of the recent cases filed against game companies have been gambling loss recovery cases. Most states that prohibit gambling include a basis for a person who loses at illegal gambling to recover their losses from the person or entity who won. A wave of these cases were filed by class action plaintiffs. In four of these cases, the district courts granted motions to dismiss the suits, finding that as a matter of law the plaintiff was not entitled to recover. The reasons for the dismissals varied. Of most significance to game companies, some courts found that virtual items, which could not be cashed out, were not “something of value.” As a result, these courts

held that winning such virtual items was not gambling.

Another basis upon which some of the courts dismissed these claims was that the game companies were not gambling winners for purposes of the gambling loss recovery statutes. The courts reasoned that when a game company sells a virtual item, it makes a set profit upon the occurrence of the transaction. It does not stand to gain or lose based on any outcome or what a player does with the virtual items. It is important to note that this basis alone does not necessarily mean there is no gambling. Rather, it means that the statutory basis for a gambling loss recovery action against a game company is not satisfied.

In all but one of the four cases that were dismissed, the plaintiff lost on appeal as well. In one case, the Ninth Circuit overturned a Washington state district court dismissal. In that case, the Ninth Circuit focused on the specific definition of “thing of value” under Washington law. Under the relevant Washington law, “gambling” is defined as:

1. staking or risking something of value
2. upon the outcome of a contest of chance or a future contingent event not under the person’s control or influence,
3. upon an agreement or understanding that the person or someone else will receive something of value in the event of a certain outcome.⁶

The Ninth Circuit’s decision largely turned on the meaning of “something of value.”⁷ It stated that under Washington state law, a “thing of value” includes any money or property as well as extension of a service, entertainment or a privilege of playing at a game or scheme without charge.⁸ The Ninth Circuit held that in the game under review, virtual chips permit a user to play the casino games and if a user runs out of virtual chips they can wait for more free chips or buy more chips to have ‘the privilege of playing the game.’⁹ Because the virtual chips extend the privilege of playing the games, the Court determined that they constitute “something of value” and fall within Washington’s definition of gambling.¹⁰

The Ninth Circuit rejected the game company’s argument that other federal courts have held that certain “free to play” games are not illegal gambling.¹¹ According to the Ninth Circuit, each case cited for this proposition involves the analysis of different state statutes, state definitions, and games.¹² According to the Ninth Circuit, “Our conclusion here turns on Washington statutory law, particularly its broad definition of ‘thing of value,’ so these out of state cases are unpersuasive.”¹³

That does not mean that the game company was found liable for gambling. It just means that the case is now back before the district court where presumably a trial will occur and a final decision on all of the issues will be reached.

In a parallel proceeding, the game company filed a petition with the Washington State Gambling Commission (WSGC) for a declaratory order that the game does not involve gambling. Interestingly, the WSGC previously published a document stating

that the game at issue did not involve gambling. This evidence was before the Ninth Circuit, but was not relied on due to it allegedly being an informal opinion and not an official administrative action. Recently, the WSGC held a hearing on that petition, but deferred a decision until later this fall.

Meanwhile, emboldened by the Ninth Circuit ruling, plaintiffs' attorneys have filed a number of additional class actions in Washington state, seeking to recover what are alleged to be gambling losses against several other game companies. These cases are still pending.

Loot Box Scrutiny

Loot boxes have been used in MMOs dating back to at least 2007. As free-to-play video games proliferated, this mechanic has been increasingly employed as a monetization technique in other games. Their increased popularity has drawn greater scrutiny.

A great debate has arisen over whether loot boxes constitute gambling. According to some, loot boxes target addictive tendencies. But these allegations are not universally accepted and seem to lack scientific evidence.

Various countries have weighed in with mixed conclusions. For example, the United Kingdom found them not to be illegal. The Netherlands and Belgium have taken a strict view and have banned certain loot box activity, threatening criminal prosecution for violators. A number of game companies have removed loot boxes from games offered in these countries.

Even if a loot box mechanism is not illegal gambling, consumer protection is another concern. In some cases, players are unaware of the odds for obtaining certain items, particularly rare virtual items, via a loot box. In May 2012, Japan's Consumer Affairs Agency (similar to the U.S. Federal Trade Commission) issued a legal opinion that effectively banned the Kompu Gacha mechanic, in part, due to allegations that some game operators did not disclose the odds of obtaining certain rare virtual items and that the odds were not fixed.

The Future of Games and Gambling

Washington State Gambling Cases and Potential Consequences

The outcomes of the matters pending in Washington state likely will have a significant impact on the industry. If the WSGC grants the pending petition and rules that the Big Fish Casino games are not gambling, it would be a huge win for the industry. It is possible, however, that it could decline to grant the petition, without ruling on whether BFG is gambling, and defer to the district court. This could leave things in limbo for a while.

If the WSGC rules that BFG is gambling, that would, at a minimum, likely impact the ability of game companies to offer certain game mechanics to players in Washington state. However, it is important to note that such a ruling could have a ripple effect. A number of other states have a definition of "thing of value" that is similar to

Washington. However, there is no guarantee that those states would necessarily find BFG to be gambling. It could interpret “thing of value” differently than Washington and/or it could find there is no gambling for other reasons. The “thing of value” issue is just one of the issues that informs a decision as to whether certain game mechanics are gambling.

Some regulators, around the world, have commented that even if certain games or game mechanics are not gambling, they raise two other concerns. One is the failure of some game publishers to disclose the odds of winning various virtual items. The second is a perception that these mechanics target or engender addictive tendencies, which could lead to problem gambling down the line. The validity of these concerns is being debated, as are potential solutions to alleviate the concerns. These are issues that will likely continue to receive additional attention.

Crypto Games

The use of blockchain technology for crypto games, such as CryptoKitties, and other token-based digital collectibles is on the rise. Also growing is the number of tokenized-asset marketplaces such as Rarebits and cryptocurrency designed specifically for games such as Enjin Coin. One of the potential advantages of crypto games is that they can provide a level of transparency as to the number of virtual items within a game economy. Another facet to crypto games is that virtual items can be represented by digital tokens. This is both good and potentially bad. It is good because these tokens can be easily tradeable. It is potentially bad because this tradability could complicate the gambling analysis. If players in crypto games can win virtual items through chance-based mechanics, and the game itself relies on tradeable tokens, this could impact the analysis of whether the items are a “thing of value” under relevant state gambling laws. Arguably, in this case, the “market” may not be an “unauthorized” secondary market, but rather a market facilitated by the game publisher. Of course, this is not to say that all crypto games will necessarily face this issue. The analysis must be done on a case-by-case basis for the relevant facts of each game.

1 See, e.g., *Humphrey v. Viacom*, 2007 U.S. Dist. LEXIS 44679, at *25-28 (D.N.J. June 20, 2007) (determining that the fees paid to the fantasy sports game operator were payment for services pursuant to an enforceable contract, and thus the player had no “gambling loss”).

2 The analysis of whether virtual items have value may depend on many factors, including: (i) how the player acquired virtual currency (e.g., whether it was paid for with real cash or earned through game play); (ii) 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); (iii) with whom can it be used (e.g., the virtual currency issuer or third parties); and (iv) the definition of thing of value in the individual states gambling statutes.

3 The Travel Act and the Illegal Gambling Business Act are both 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.

4 Because some states (Nevada, Oregon, Delaware and Montana) already had state-authorized sports wagering before the enactment of PASPA, statutory exceptions allow them to continue permitting certain sports betting.

5 See *Murphy v. NCAA*, 138 S. Ct. 1461 (2018) (striking down the prohibition of state authorization of sports gambling under PASPA as unconstitutional).

6 Wash. Rev. Code § 9.46.0237.

7 See *Kater v. Churchill Downs Inc.*, 886 F.3d 784, 787-788 (9th Cir. 2018). 8 *Id.* at 787 (quoting Wash. Rev. Code § 9.46.0285) (emphasis added).

9 *Id.*

10 *Id.* at 787-788.

11 *Id.* at 788.

12 *Id.* (citing *Mason v. Mach. Zone, Inc.*, 851 F.3d 315 (4th Cir. 2017); *Phillips v. Double Down Interactive LLC*, 173 F. Supp. 3d 731

(N.D. Ill. 2016); *Soto v. Sky Union, LLC*, 159 F. Supp. 3d 871 (N.D. Ill. 2016).

13 *Id.* This might suggest that this case is a unique decision based on the specific facts and specific state law. However, a number of other states' gambling statutes define a "thing of value" in a manner similar to Washington state. It is possible that cases will be brought under these other states' laws to test the applicability of those laws to similar game mechanics. Companies operating with this mechanic may want to consider whether serving users in those states is prudent pending further developments.

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