

INTERNET LAW - II

INTERNET GAMBLING

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This article will provide a general overview of the status of Internet gaming today, including an overview of attendant legal issues and developments. Substantial Web construction activity is evident and it is reasonable to anticipate that one or two new Internet gaming sites will be added per month. The next stage of development of Internet gambling will be the advent of well financed and brand-powerful entities, as well as governments and quasi-governmental entities. When these entities move in, they are likely to be highly successful because they will be perceived by patrons as providing Internet casino gambling comparatively free of risk with respect to the integrity of the games, the solvency of the operator, the security of the Web site, and security of the related financial transactions.

EXECUTIVE SUMMARY

Background

The handle (the aggregate amount wagered) for gambling in the United States was approximately US\$587 billion in 1996, with revenues (the amount lost by patrons) of approximately US\$47 billion. The estimated 1997 handle for Internet gaming is in excess of US\$1.2 billion, and revenues from Internet gaming are expected to reach US\$10 billion by the Year 2000.

Internet Gambling Opportunities

It appears that well funded competitors who can offer the perception of honesty and integrity through premium branding in this new industry can make extraordinary profits, certainly in the range of 10% of the handle. The United States federal and state legislative actions to prohibit Internet gambling, and the anti-gambling laws in other countries, may present a unique opportunity for emerging countries to generate critical tax (or gambling operation) revenues and/or for well funded entities with branding capabilities to dominate the space by providing lush, secure, regulated, and taxed, environments where patron concerns for the integrity of the games and the associated financial transactions are eliminated.

The Advent of Powerful Internet Casino Operators and Others

Emerging countries recently stung by the United States Federal Communication Commission ruling with respect to international tariffs that will result in severe reductions in telecommunications tariff revenues may well be the first to enter into the lucrative Internet casino operations market place.

There will also be opportunities for well funded organizations with significant branding capacities to establish their

space in Internet gaming and to minimize the risks of illegality by taking appropriate precautions with respect to maintenance of operations offshore, and the implementation of policies and procedures that will effectively ban citizens from gambling on that site from locations where it is illegal to gamble on the Internet.

A third type of competitor may also emerge: one that is well funded, with strong brand ownership, and which is willing to expend the funds to develop and maintain a high quality Internet casino Web site as a branded 'place card' in the event that Internet gaming is legalized in its home country. For the near term, these competitors will only offer the casino style games 'for fun' so as to minimize the risks of illegality. The costs of maintaining such a site could be mitigated through the sale of advertising, and Web site traffic may be enhanced by offering sweepstakes style prizes to visitors.

A fourth group of entrants is also likely to emerge, made up of the legal and strategic planning firms possessing subject matter knowledge and experience with E-commerce, who will assist in development of prototypical strategic plans, from a legal, branding, and financial perspective. Joining these strategic planners will be the third party developers of software, who will enable off-the-shelf gaming software to be integrated into appealing and seductive Internet gambling Web sites. Critical to the arrangements among the parties will be the warranties of functionality of the software, detailed product specifications, indemnifications as to ownership, and claims by third parties, as well as escrow agreements and other fiduciary arrangements to create the perception and reality of the financial solvency of the Internet casinos.

Conclusion

With the prospect of generating significant taxes and/or operating profits of over 10% of the handle, emerging countries

and well funded organizations with strong branding capacities are likely to enter and then dominate the Internet gaming space irrespective of anti-gambling legislation in the US and in other countries.

INTERNET GAMBLING

1. Internet Gambling as it Exists Today

Winners Publishing's Casino Guide (<http://www.winner.com/guide.html>) provides hot links to numerous Internet gambling Web sites. Casino style and other gambling Web sites are principally maintained in Antigua, St. Kitts, Granada, Dominica, Belize, the Turks and Caicos Islands, and other Caribbean locations where regulation and taxation are available. For example, it is anticipated, that Antigua will receive in excess of US\$3 million of tax revenue relating to gaming operations this year.

Verifiable financial information is very hard to obtain, and when numbers are quoted they seem to be very high. For example, Internet Casinos recently reported that it runs six cyber-gaming sites and takes in over US\$60 million in bets each month from 400 000 regular patrons, yielding monthly revenue of US\$7.5 million per month and monthly net income of approximately US\$6.5 million. The operations of Internet Casinos may or may not represent a reasonable economic model for an Internet casino.²

2. Evaluation of the Future Development of Internet Gambling

There would appear that three types of entities will have the opportunity to enter and then dominate the Internet gaming space. The first are governmental or quasi-governmental entities seeking additional tax revenues that enter the space with experienced economic and operational partners. The second are funded organizations with significant branding capacity, that are willing to mitigate the legality risks through implementation of procedures to exclude players from locations where Internet gaming is illegal, or likely to be found illegal. The third are well funded organizations, with strong branding capacity, that wish to put a 'place card' down in the Internet gambling space, but who choose to offer the game for free to minimize the risks of illegality.

For the first two groups, it would appear that very significant revenues can be generated on an annuity basis. By way of illustration, if Internet gaming revenues reach US\$10 billion in 2000 and if all such revenues were taxed based on the revenue model of Internet Casinos at the rate of 10% of revenue, the host countries would receive an aggregate of US\$1 billion. By contrast, based on this model, if Internet gaming was conducted by host countries as actual casino operators, the net revenues to those host countries would exceed US\$9 billion.

2.1. Governmental and Quasi-Governmental Casino/Lotto Operators

Although, some countries (e.g. Liechtenstein and Germany) have already entered the Internet gaming space with lotto offerings, there has yet to be an offering of casino style

Internet gaming by a governmental or quasi-governmental entity.

However, it appears inevitable that some emerging countries with the need to bolster revenues will turn to Internet gaming as a solution, particularly in the wake of the substantial impact of the US Federal Communications Commission's recent mandate that US-based international telephone carriers renegotiate tariffs with foreign telecommunications companies. High telecommunications tariffs have long been a substantial source of revenue for these emerging countries and Internet gaming could provide a very appealing opportunity for those countries to replace lost revenues, particularly if the gaming is conducted principally by players located outside the host country.

As noted, the Liechtenstein and German lotteries are currently doing significant business on the Internet, and with the advent of the use of the Internet by the State of New York in connection with horse racing, certain 'legitimized' Internet gaming can be anticipated to emerge. In the United States, the State of New York's attitude towards the Internet, and what some view to be the likelihood that Lotto will be permitted to be conducted by Indian tribes if restricted to residents of states where lottos are presently conducted (there are 36 states which currently have some form of lotto), are likely to encourage this 'legitimization'. This trend to 'legitimization' should shorten the time period before some emerging economies turn to Internet casino gambling, not just lotto style gambling, as a source of revenues.

2.2. Well Funded Casino Operators With Significant Branding Capacities

Of the Web sites viewed in connection with the research for this White Paper, the most lush Web sites were hosted by Acropolis Casinos (<http://www.acropoliscasinos.com>) and Caribbean Cyber Casino (<http://www.ccasino.com>). Somewhat down scale from Acropolis Casinos is Casino Royale, where the minimum purchase is US\$10 and the minimum bets range from US\$.20 to US\$.25. (<http://www.fun-scape.com>). Not only are these sites impressive, but it is clear that improvements are being made at a very rapid rate which will permit the Internet casino operator to give a very 'casino-like' experience. With Web site development costs dropping, particularly as a result of available casino software, highly seductive casino environments will be capable of being constructed for under US\$2 million. With patronage solicited emphasizing the operator's economic strength and with legal risks mitigated by establishment of operations in a host country which both regulates and taxes, such operators can also be advantaged by co-branding through advertising with luxury style brands. It would appear to be unlikely that any US organization would risk involvement with Internet casino gambling, although non-US entities may feel less constrained given the extraordinary profits available.

2.3. Some Competitors May Determine to Establish a Place Card in Internet Gaming by Offering Casino Gambling 'Just For Fun'

Some US companies, particularly those in the entertainment business may be willing to forego current revenues and pro-

vide 'play for free' Internet casino gambling until such time as Internet gaming becomes legal in the US. Models may even develop whereby these place cards are enriched through screened sweepstakes events, which will reward Web site visitors.

2.4. Lawyers, Consultants and Software Developers are Expected to Emerge

A fourth group of entrants is also likely to emerge, made up of the legal and strategic planning firms possessing subject matter knowledge and experience with E-commerce, who will assist in development of prototypical strategic plans, from a legal, branding, and financial perspective. Joining these strategic planners will be the third party developers of software, who will provide off-the-shelf gaming software that can be integrated into appealing and seductive Internet gambling Web sites. Critical to the arrangements among the parties will be the warranties of functionality of the software, detailed product specifications, indemnifications as to ownership, and claims by third parties, as well as escrow agreements and other fiduciary arrangements to create the perception and reality of the financial solvency of the Internet casinos.

3. Present and Anticipated Issues of Legality

3.1. In the United States, Regulators, Traditional Casino Operators, and Online Casino Operators are Locked in a Struggle Fuelled by Fear and Power

Internet gambling in the United States is presently the subject of a struggle where (1) federal and state governments seem bent on prohibiting Internet gambling; (2) the traditional casino operators are supporting the concept of prohibition and avoiding Internet gaming; and (3) a number of small operators are offering Internet gaming and employing a variety of methodologies to protect themselves. Wisconsin Attorney General James Doyle may have captured the situation in the most candid light. In a recent interview, he stated, "We don't expect to stop all online gambling, but I think a federal law will keep the legitimate operators out of it. The people who are making their money legally will be very reluctant to enter it."³

3.1.1. It is Generally Acknowledged that a US Prohibition Against Internet Gambling Cannot be Enforced

Perhaps the most daunting problem faced by US state and federal lawmakers is that it is next to impossible to effectively enforce prohibitions on Internet gaming. Whether law enforcement seeks to put the 'squeeze' on the Internet casino operator, the Internet or online service provider, the player, the index provider, or the credit card companies and banks, they will have their work cut out for them. Regardless of which group gets the 'squeeze' from federal or state government, the most likely result will be to drive both operators and players underground, and to accelerate the use of electronic cash and surrogate computers to ensure anonymity. Since state and federal governments have no way to eradicate

Internet gaming completely, the better approach may be through regulation and certification. At least then, players could choose whether to gamble at a site that is certified, or one that has not submitted itself a certification process. But, by and large, federal and state regulators have been gaining headlines by pressing for prohibition.

3.1.2. Some States in the United States Have Spoken With Force

In Minnesota, Attorney General Hubert H. Humphrey, III, has just survived the appeal process in connection with his action against Granite Gate Resorts, d/b/a On-Ramp Internet Computer Services, and Kerry Rogers, its owner.⁴ In response to the state's charges of deceptive trade practices, false advertising and consumer fraud, the defendants claimed that the court did not have jurisdiction over the action. However, the appellate court ruled that defendants' Internet advertising subjected them to personal jurisdiction in Minnesota. Specifically, it found that the defendants had "purposefully availed" themselves of the privilege of doing business in the state, because residents of the state had accessed the Web site and called the toll-free number provided; and at least one Minnesota resident was placed on defendants' mailing list. The Court concluded that because the other requirements for personal jurisdiction were met, hauling defendants into Minnesota state court did not violate due process.

In like manner, Missouri Attorney General Jay Nixon filed a lawsuit in state circuit court to enjoin the Coeur d'Alene Indian Tribe from marketing and offering its Internet gambling services to Missouri residents. Representatives of the Tribe and Executone Information Systems (a parent of Unistar Entertainment, Inc., which operates the site) stated that the Tribe would only respond to gaming requests from residents of states that have a state run lottery. In fact, there are currently 36 states that offer such lotteries. Moreover, the Missouri lottery had offered a similar game to the "Lucky 21" game available on the Tribe's Web site. This case has since been removed to Federal Court.⁵ The evolution of this case will be particularly interesting in light of the existing European lotteries. More particularly, the Liechtenstein lottery has been conducted on a cross-border basis for some time, but no state attorney general has taken action against them.

Attorney General Nixon also brought the nation's first criminal indictment of an online gaming operation when a grand jury indicted Michael Simone and his Philadelphia-based Interactive Gaming and Communications Corp. for running an illegal Internet gaming operation that accepted bets from Missourians.⁶ Interactive Gaming responded by saying that its casino and sports book operation takes place in Granada, the Caribbean island where its computers are based, and the players 'arrive' there electronically. After the indictment, a Pennsylvania judge ordered Simone to surrender his passport, and forbade him from travelling outside Pennsylvania except to surrender in Missouri. Simone and his Interactive Gaming and Communications Corp. face charges of promoting gambling in the first degree.

Not to be outdone, Nevada has become the first state to adopt a law that specifically bars its residents from placing or accepting bets over the Internet.⁷ Query how the law may be enforced and whether it will have any true effect.

Nevertheless, it is not an unexpected development for the state whose economy is most dependent on gambling.

3.1.3. Federal Legislators Are Also Lining Up Behind Prohibition

The reaction of some Internet gaming operators to the activities of Messrs. Humphrey and Nixon, as well as their concern over the proposed Internet Gaming Prohibition Act of 1997⁸ (which would make Internet gambling a federal crime), has been to take steps to limit their patrons to residents outside of the United States.⁹ Last year, Congress created the National Gambling Impact Study Commission. The Commission is to submit a report analyzing the impact of gambling in American society in 1999. Pressure on the Internet gambling operators is also likely to increase in light of the National Association of Attorneys General's formation of an Internet Working Group to amend the Federal Wire Communications Act to ensure that Internet gambling is illegal and that jurisdiction is available. The Internet Working Group will also coordinate with the Department of Justice and The Federal Trade Commission with regard to enforcement — but therein lies the conundrum. All this activity may be to no avail since it is almost certain that skillful Internet casino operators will be able to operate with impunity if they stay offshore, aloof from physical contact in the United States.

3.2. The Illegality of Internet Gambling in Canada, the United Kingdom, Singapore, Hong Kong, and the Peoples Republic of China Seems Reasonably Settled

Although the matter is not free from doubt, it is likely that Internet gaming is illegal in Canada, the United Kingdom, Taiwan, Singapore, the People's Republic of China, and Hong Kong. But Antigua, Dominica, Grenada, the Turks and Caicos Islands and other nations have established licensing and taxing arrangements for Internet gaming. With sovereign nations engaged in supporting Internet gaming, it would appear unlikely that Internet gambling will not grow and prosper in the international community.

4. Conclusion

With the prospect of generating taxes equivalent to 1% of the handle, or operating profits of over 10% of the handle, emerging countries and well funded organizations with strong branding capacities are likely to enter and then dominate the Internet gaming space irrespective of antigambling legislation in the US and in other countries.

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Footnotes

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²By contrast, Interactive Gaming and Communications Corp. (Interactive Gaming) indicated in its 1996 Form 10-K filed with the Securities and Exchange Commission on 31 March 1997, that with a handle of US\$58 482 731 it had net revenues of only US\$2 898 495 and sustained a US\$695 920 loss based on expenses of US\$3 594 515. However, the Interactive Gaming domestic presence in Pennsylvania and its move from Antigua to Granada contributed to a 48% increase in expenses, with 'only' a 22% increase in revenues for 1996. Revenues also decreased due to interruption of business caused by Hurricane Luis in September 1995. The filing by Interactive Gaming further reflected the fact that customers' credit balances and security deposits exceeded cash by US\$1 052 729.

³*Inter@ctive Week*, August 25, 1997, p. 48 quoting Wisconsin Attorney James Doyle.

⁴*State of Minnesota v Granite Gate Resorts Inc.*, No. C6957227 (Minn. Ct.App. Sept. 5, 1997).

⁵*State of Missouri v Couer d'Alene Tribe*, 1997 U.S. Dist. LEXIS 14980 (W. Dist. Mo., 1997).

⁶*Missouri v Interactive Gaming & Communications Corp. et al.*, 197CR 0014(1)(MO Cir. Ct. Greene Cty.) filed June 26, 1997.

⁷1997 Nev. Stat. 663.

⁸S.474, an amendment to the Federal Wire Communications Act sponsored by Senator John Kyl (R-Arizona) was introduced on 19 March 1997, and an amended version was passed by the Senate Judiciary Committee in October. The companion bill was introduced into the house by Representative Robert Goodlatte (D-Virginia) on 3 September 1997 (H.R. 2380).

⁹For example, Virtual Gaming Technologies Inc., a San Diego-based company will not permit US residents to order the software necessary to gamble at its site.