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Expert Analysis

Daily Fantasy Sports: Fun and Games Until Courts Decide It's 'Gambling'

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The young daily fantasy sports (DFS) market is exhibiting exponential increases in both players and spending per player. That makes online tournament operators, currently hungry for capital, potentially exciting candidates for investment.

When projecting returns, however, investors should not underestimate existing legal risks or the chance public opinion may sour on online gaming. Despite popular belief, existing federal gambling laws do not protect DFS gaming; rather, they give teeth to myriad state gaming laws that may constrain DFS.

A comprehensive analysis of DFS's legal viability requires examining each state's laws and political trends. To project possible future returns, we encourage investors to examine tournament operators' entry-fee revenues—broken down by state—and weigh the likelihood that any particular stream of revenue will be lost to unfavorable judicial or legislative response within a state. This analysis has become more crucial than ever as the first stories of DFS scandal reach larger audiences and as state gaming boards, attorneys general and federal law enforcement increasingly question DFS's propriety.

What Is DFS?

Fantasy sports gaming is over a half-century old. Traditionally, fantasy tournaments coincide with a given sport's season. During the season, players create "teams" of real-life athletes, win points based on athletes' performance and periodically revise their rosters. The player with the most points at the season's end wins.

Daily fantasy sports is an evolution of traditional tournaments made possible by the Internet. In DFS, players log on to websites to build and revise ros-

ters, pay entry fees, and are awarded points based on athletes' performance over the course of only a few days. As tournament organizers, DFS website operators take a percentage of the entrance fees—typically around 10 percent.

State of Play

Precise DFS market size estimates have proved elusive, but gaming analysts generally agree that it is large and growing exponentially. The Fantasy Sports Trade Association (FSTA) estimates that 56.8 million North Americans play either traditional or daily fantasy sports (up 36 percent from 2014). The two largest DFS sites, FanDuel and DraftKings, together reported almost \$1 billion in entry fees for 2014, up nearly tenfold from 2013.

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This year, the two expect to distribute \$3 billion in prizes. (By comparison, \$3.6 billion was wagered in sports betting in Nevada in 2013, according to Eilers Research LLC.)

Currently, FanDuel and DraftKings represent about 96 percent of the market, but two other established firms joined them this year: Yahoo decided to leverage its existing online gaming platforms (which have long included traditional tournaments) and sports reporting infrastructure to provide DFS tournaments, and Montreal-based Amaya, which owns for-cash gaming sites Poker Stars and Full Tilt Poker, acquired a DFS site, naming it StarsDraft.

DFS offers a highly scalable business model with little fixed overhead, but the firms also seem



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to expect only those with the most recognizable brands, most players and largest prizes to survive. They are pouring cash into some of the United States' most expensive marketing campaigns in a land rush to accumulate players. At least for now, private DFS firms are relying heavily on external financing to help fund these expenditures.

Private equity and venture capital firms, national league associations and many team owners already have invested in the major DFS sites. In July, DraftKings raised \$300 million in private funding, joining FanDuel in the club of "unicorns"—or, start-up companies with \$1 billion-plus valuations. Publicly traded Amaya quadrupled in market capitalization over 2014 and 2015, as investors anticipated its entry into DFS.

There are many reasons for DFS investor enthusiasm—growth in entry fees, potential cross-promotional income from television sports tie-ins and untapped international markets being among them. On the other hand, there are reasons for investor caution—particularly, legal and political risk—that are difficult to quantify but whose threat to DFS operations is becoming increasingly apparent.

DFS Under Law: Fair or Foul?

A material risk to DFS is the possibility that playing for cash will be deemed illegal "gambling" within significant U.S. jurisdictions. This is not merely theoretical—when Preet Bharara, U.S. attorney for the Southern District of New York, indicted the three

largest online poker companies on April 15, 2011 (so-called “Black Friday”), the sites closed their games to U.S. players and initiated insolvency proceedings shortly thereafter.

The media often has referred to fantasy sports as a “legal” form of online gambling, noting that the federal statute used on Black Friday, the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA), excludes certain fantasy sports games from its scope. Its provisions, however, do nothing to authorize DFS gaming and expressly do not preempt state laws, which may prohibit betting on games like DFS.

In general, federal anti-gambling laws supplement state laws by making federal crimes out of various activities related to gaming that is illegal at the state level. Aside from UIGEA, other federal anti-gambling laws include the Federal Wire Act, Travel Act, Illegal Gambling Business Act (IGBA) and Professional & Amateur Sports Protection Act. Notably, these other statutes do not include carve-outs for fantasy sports.

Absent new legislation, it will be the courts that must clarify the legal standing of DFS in each state. In doing so, judges will be required to call upon common law principles to interpret anti-gambling codes that were almost universally drafted before online fantasy sports existed.

Evaluating DFS’s legality requires examining more than a few federal statutes. The legality of someone placing DFS bets from within a state is determined under each such state’s laws. There is no “uniform” gaming code, and little state legislation has expressly addressed fantasy sports. DFS operators have long viewed Arizona, Louisiana, Iowa, Montana and Washington as prohibitive states, while only Kansas and Maryland have passed legislation permitting play. To various extents, the legality of DFS is unclear everywhere else.

That may be changing quickly. In October, Nevada’s gaming board, backed by the state attorney general’s opinion, declared DFS to be gambling, shuttering the state to all unlicensed operators. Earlier, the U.S. Attorney’s office in Tampa, Fla., convened a grand jury to consider possible violations of Florida law and the IGBA, which makes running a gambling business that is illegal under state law a federal offense. Yahoo promptly abandoned the state, and Avaya eliminated for-cash play in all U.S. states except four where favorable DFS guidance exists. Elsewhere, the attorneys general of Massachusetts (home to DraftKings) and New York expressed public views for and against DFS, respectively.

Both the Illinois and Michigan gaming control boards decided that playing DFS for cash is illegal, although their attorneys general have not commented. Bharara in New York and the Federal Bureau of Investigation in Boston have

begun investigations, as well, according to The Wall Street Journal.

Absent new legislation, it will be the courts that must clarify the legal standing of DFS in each state. In doing so, judges will be required to call upon common law principles to interpret anti-gambling codes that were almost universally drafted before online fantasy sports existed. When courts have analyzed analogous activities (such as traditional or digital versions of card games), their holdings have varied considerably from state to state.

That said, the states can be broadly organized by their relative tolerance of “betting” (i.e., paying for the opportunity to win a prize) among participants depending on the level of skill, as opposed to chance, involved in determining a game’s outcome. Some jurisdictions, such as Florida, do not permit players to bet any of their own money, even if the prize is determined purely by skill. In most jurisdictions, however, state law requires courts to determine whether a game is a legitimate competition of “skill” or an illicit “game of chance.” Distinctions between games of “skill” and “chance” will vary based on a court’s view of the relative amount of risk that is permitted to influence a game’s outcome according to state jurisprudence. Most states are “dominant factor” states, where courts will ask whether or not the contribution of risk to a game’s outcome outweighs that of participants’ skill. Some ban betting where there is a “material” amount of risk, while other states lower the threshold to “any” risk at all. To count on reliable revenues from a particular state, DFS operators and investors must consider whether cash contests offered therein meet its “game of skill” requirements.

DFS and Poker: Two of a Kind?

So far, there are no cases that seriously examine whether fantasy sports is a game of skill. Poker case law, which is plentiful, may provide the closest precedent. Professional players and aficionados will argue that consistent success in poker requires countless hours of practice and genuine skills, including emotional discipline, knowledge of probabilities, game theory and player psychology and, for some tournaments, even physical endurance. DFS arguably requires a similar degree of skill in that it tests players’ math and statistical abilities, sports knowledge, attention to detail, and, in fast-paced online daily tournaments, emotional fortitude and ability to multitask. Perhaps unsurprisingly, many of the best online poker players, so-called “sharks,” have migrated to DFS where they now repeat their success.

Nonetheless, state courts broadly have held poker to be a game of “chance.” In testing poker’s legality, court opinions generally hold that the inquiry into risk’s influence is a qualitative not quantitative test. Courts typically have examined the influence of chance on a given round of cards, where an unlikely deal could give victory to a greenhorn over a veteran player. Likewise, courts typically ignore the role of skill over the course of a game or tournament where participant expertise becomes decisive. Among the 15 largest states, all but Arizona, Florida and Illinois require a judicial “skill”-versus-“chance” inquiry. Of those

12, the courts or attorney general in every state except California have decided poker is a game of “chance.”¹

The dichotomy between player and judicial opinion concerning poker may not bode well for DFS contests, especially those that can be won or lost based on the results of a small handful of real-life games. Although skilled sharks overwhelmingly beat novice minnows in the long run, scores in any individual contest are vulnerable to chance events like flukish weather, player injuries or botched referee calls. Unfortunately for DFS, if poker case law is a guide, the more that a given round of play is determined by serendipity, the more likely a court will find it to be a game of chance.

Court of Public Opinion

Given the current legal landscape, state and federal prosecutors likely have tenable arguments to mount legal challenges to DFS in many, if not most, states. Though law enforcement may have the way, it remains unclear whether the political will exists to shut down an increasingly popular pastime.

Ultimately, the viability of DFS may depend on how it fares in the public’s eyes. The industry has begun lobbying blitzes and already has secured statutory protection in Kansas and Maryland and favorable regulation in New Jersey. Their efforts, however, may face uphill battles in other locales where DFS-friendly bills have floundered. In 2015, DFS news coverage also grew increasingly strident. Today the industry must weather coverage from larger outlets like CNBC, The New York Times and The Wall Street Journal, which have begun to investigate industry practices.

Bad press likely has already hurt business. Autumn’s spike in negative legal and regulatory opinions coincided with media coverage of a DraftKings employee potentially using inside company information to build teams on FanDuel. With no government or self-regulatory oversight, the potential for more scandals remains. Security and data breaches, game-rigging by athletes or refs, mishandling of player funds, access by minors or players from prohibitive states and gambling addiction and consumer protection concerns could undermine public and political goodwill.

DFS investors should remain alert during the coming months. Absent widespread lobbying success, it is increasingly unlikely that DFS can operate wholly outside of state frameworks for licensing, regulating and taxing gaming establishments. It’s possible some states that are historically resistant to gambling and lotteries may never permit DFS. Given the checkerboard of U.S. gambling regulations, investors should take a cue from the best DFS contestants and weigh the odds of various outcomes before making their play.

1. California courts have not tested traditional poker, but some precedent suggests they would appreciate the contributions of player skill, so long as there are not lottery-like “jackpots” at play.