

# K&LNGAlert

NOVEMBER 2005

## Internet Gaming Internet Gaming: The Role of the Dormant Commerce Clause

In the United States, 48 of the 50 states allow some form of legalized gaming. Many of these 48 states, however, have laws in place that limit the ability of their citizens to make wagers with out-of-state providers of gaming. The increase of Internet gaming sites is putting these laws in the spotlight. One rationale in support of these laws is the protection of the economic interests of in-state providers, often the state itself in those states that operate state lotteries. Perhaps because states have general police power to regulate in areas of “legitimate local concern,” there have been no legal challenges specifically aimed at the state laws that discriminate against out-of-state gaming providers. But, this may change in light of U.S. Supreme Court’s recent decision in *Granholm v. Heald*.

In *Granholm v. Heald*, the U.S. Supreme Court applied the dormant Commerce Clause<sup>1</sup> to strike down state laws in Michigan and New York that discriminated against out-of-state wineries. The Michigan and New York laws concerned the direct shipment of wine to consumers. Under the Michigan law, in-state wineries could obtain a license allowing them to ship wine directly to consumers, while direct shipment from out-of-state wineries was prohibited. Wine produced out-of-state had to “pass through” an in-state wholesaler and retailer before shipment to the consumer. This not only made out-of-state wine more costly, but also made it difficult, if not impossible, for small, out-of-state wineries to secure wholesalers for their small quantities of wine, effectively barring small, out-of-

state wineries from the Michigan market. While New York did not prohibit out-of-state wineries from shipping directly to consumers, it allowed in-state wineries to sell on more favorable terms. Out-of-state wineries could ship to New York consumers *only* if they established a branch factory, office, or storeroom in New York, thereby increasing their overhead. And, even after out-of-state wineries established a presence in New York, they were still ineligible for “farm winery” licenses, which were granted only to wineries selling wine made exclusively from grapes grown in New York. Under farm winery licenses, wine could be shipped to consumers without obtaining a separate certificate from the state, as was required by all others desiring to ship directly to consumers. Finally, New York allowed in-state wineries, but not out-of-state ones, that did not have direct shipment licenses to ship their wine to consumers through wineries with such licenses.

The Court began by stating the well-established rule that “in all but the narrowest circumstances, state laws violate the [dormant] Commerce Clause if they mandate ‘differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.’” The Court also explained that while two federal statutes – the Wilson Act and the Webb-Kenyon Act – gave states the power to regulate liquor produced out-of-state on the same terms as liquor produced in-state, they did not authorize discrimination against out-of-state liquor and did not overrule the early dormant Commerce Clause cases

<sup>1</sup> The Commerce Clause provides that Congress shall have the power “to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” U.S. CONST. Art. I, § 8, cl.3. When a state law burdens interstate commerce or discriminates against out-of-state interests, the violation may also be referred to as a violation of the “dormant Commerce Clause” or the “negative implications of the Commerce Clause.”

that struck down discriminatory state laws. The Court went on to reject the argument that the 21<sup>st</sup> Amendment, which repealed prohibition and provided for state regulation of liquor, displaced Commerce Clause restrictions with respect to state liquor laws. The 21<sup>st</sup> Amendment did not give states the power to pass non-uniform laws that discriminate against out-of-state goods.

The *Granholm* Court then considered whether the regulatory schemes in Michigan and New York advanced legitimate state purposes that could not be served by reasonable nondiscriminatory means. The states' claim that limiting out-of-state, direct shipment of wine decreased the risk of underage drinking failed because the states provided insufficient evidence of the problem. The Court also pointed out that there are less restrictive means of preventing underage drinking, such as requiring an adult signature upon delivery. Moreover, the discriminatory aspect of the laws was not justified because minors are just as likely to order a direct shipment of wine from an in-state winery as from an out-of-state winery. Similarly, the Court rejected tax evasion as a justification, because it saw no difference between in-state and out-of-state direct shipping in the potential for tax evasion. Other rationales such as protecting the public's health and safety, ensuring regulatory accountability, and facilitating orderly market conditions failed because they could be achieved through an evenhanded licensing scheme.

In sum, Michigan and New York failed to meet their burden of showing that the discrimination against out-of-state commerce was justified, because nondiscriminatory alternatives were available for policing direct wine shipments. As a result, despite the states' broad power to regulate liquor under the 21<sup>st</sup> Amendment, the Court struck down the Michigan and New York laws because they discriminated against out-of-state interests in violation of the dormant Commerce Clause.

The arguments presented by Michigan and New York in the *Granholm* decision are similar to the arguments often advanced regarding the legitimacy of state regulation of out-of-state gaming. The effect of provisions that prohibit a state's citizens, i.e., consumers, from placing wagers out-of-state is to restrict the opportunities of gaming interests located out-of-state in favor of protecting in-state gaming interests. Under traditional dormant Commerce Clause principles when examined in the light of the *Granholm* decision, efforts to limit the ability of in-state gamblers to place out-of-state wagers may well be subject to challenge.

The impact of the *Granholm* decision on state gaming regulations is particularly important because of the Supreme Court's interpretation of the Michigan and New York statutes in light of the 21<sup>st</sup> Amendment. Gaming, like alcohol, is an area that has been largely left to the states to regulate under their inherent police power. Because of this, states have passed laws concerning gaming, without considering whether the law discriminates against out-of-state interests. But in *Granholm*, the Court concluded such was not constitutional. The Court explained that although the 21<sup>st</sup> Amendment gives states the right to regulate alcohol, it does not give them the right to pass laws that discriminate against out-of-state alcohol. Based on *Granholm*, a court faced with a challenge to an alleged discriminatory gaming law could find that a state's right to regulate gaming also does not include the right to enact discriminatory laws and would evaluate any such challenge using traditional dormant Commerce Clause analysis.

Under the traditional dormant Commerce Clause, Nevada's gaming law, Nevada Revised Statutes ("NRS") §§ 465.091 – 465.094, is an example of one that would be likely not to pass scrutiny. This law essentially makes it illegal for out-of-state establishments to accept bets from citizens in Nevada.<sup>2</sup> It prohibits persons or entities from

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<sup>2</sup> The law includes wagers placed on the Internet. See NRS § 465.091.

accepting wagers from any person physically present in the state of Nevada unless (1) the wager is placed by an individual; (2) the wager is placed with a race or sports pool licensed by Nevada, a person licensed by Nevada to engage in off-track, pari-mutuel wagering, or a person or establishment licensed under Title 41 (Gaming, Horse Racing, Sporting Events) of NRS; and (3) the wager is accepted or received within the state of Nevada. Although Nevada has a legitimate interest in policing the safety and trustworthiness of the gaming activities in which its citizens participate, it cannot provide protection by discriminating against out-of-state businesses. Like the Michigan and New York laws providing favorable treatment to in-state wineries, the Nevada law provides favorable treatment to in-state gaming establishments by eliminating out-of-state competition. Nevada would likely have a hard time justifying this law as the least restrictive means to protect its citizens when it could employ other nondiscriminatory alternatives, such as an evenhanded licensing scheme, to accomplish the same result.

New York and New Jersey law regarding wagers on horse racing are also suspect. New York racing law allows only tracks located in-state to accept wagers from New York citizens. NY Rac. Pari-M. §1012. New Jersey law requires that “no entity, other than the account wagering licensee, shall accept an account wager from a person within this State.” (N.J. Stat. § 5:5-142 (2005)). Under the law in both states, betting on horse races is legal both on and off-track. Additionally, federal law provides that under the Interstate Horse Racing Act, betting on horse races between states is legal so long as both states allow betting on horse races. Although legal in-state, the laws of both states make it illegal for an off-track betting establishment located out-of-state to accept a wager placed by a resident of New York or New Jersey, respectively. As with the Nevada law, both New York and New Jersey will likely face dormant Commerce

Clause challenges based on the refusal to allow their citizens to place wagers with companies licensed and located in other states.

A state’s argument that federal statutes such as the Wire Act, the Johnson Act, and the Transportation of Gambling Devices Act were passed specifically to assist the states in regulating gambling and, therefore, Congress has explicitly recognized the preeminent state interests in controlling gambling will likely also face scrutiny. As the Court explained in *Granholm* when that argument was made with respect to the Wilson Act and the Webb-Kenyon Act, the extension of the right to regulate to the states does not equate to a right to discriminate against out-of-state gambling interests and does not overrule general Commerce Clause principles. As a result, courts facing a challenge to legislation prohibiting in-state consumers from wagering out-of-state will have to determine whether the legislation advances a legitimate state interest that cannot be served by less discriminatory means. The states will likely argue that such legislation advances a local interest in protecting citizens from placing wagers with disreputable entities, in ensuring that underage gambling is not taking place, and in maintaining regulatory control of the entities accepting wagers. While these may be legitimate and valid concerns, states that permit in-state gaming will have to show that these interests are furthered by restricting wagers to in-state activities and that there are no less discriminatory means available to address these concerns. Absent the showing of a legitimate state interest, the laws in the states that prohibit citizens from engaging in the same activity through out-of-state providers as they are able to engage in in-state may likely be challenged under the dormant Commerce Clause.

The *Granholm* decision’s most obvious implications in the gaming realm are in cases where state authorities choose to license some form of gambling

in-state while also attempting to prohibit its citizens from engaging the services of out-of-state providers. This contradiction currently exists in the area of pari-mutuel account wagering. Although many states authorize off-track entities located and licensed in-state to accept wagers from in-state citizens, they make it a crime for out-of-state entities to accept the same wagers from in-state citizens. Account wagering entities operating out-of-state may likely seek declaratory relief regarding the constitutionality of such laws, or assert the dormant Commerce Clause as a defense in an action by the Attorney General of one of these states alleging violations of these laws.

Additionally, because of the number of states considering legislation regarding Internet gaming, the same analysis will likely apply in that area in the coming years. Legislation that legalizes on-line gaming by citizens with in-state providers while criminalizing the same conduct with out-of-state

providers will likely face dormant Commerce Clause challenges. Although the potential in-state revenues will certainly motivate states to try to keep gaming in-state, under current federal precedent, the constitutionality of such conduct remains questionable.

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