UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF CALIFORNIA

LARRY C. FLYNT; HAIG KELEGIAN, SR.; HAIG T. KELEGIAN, JR., Plaintiffs, v. STEPHANIE K. SHIMAZU, in her official capacity as the Director of the California Department of Justice, Bureau of Gambling Control, et al., Defendants.	No. 2:16-cv-02831-JAM-EFB **ORDER GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTION TO DISMISS**

Larry Flynt, Haig Kelegian, Sr., and Haig Kelegian Jr. own card clubs in California. Flynt and the Kelegians want to substantially invest in out-of-state casinos, but California law prohibits them from owning more than a one-percent interest in facilities that host casino-style gambling. In 2016, Plaintiffs challenged the constitutionality of this prohibition, arguing it violates the Due Process Clause and the dormant commerce doctrine. Compl., ECF No. 1. Plaintiffs have since abandoned their due process claim. See Flynt v. Shimazu, 940 F.3d 457, 460 n.2 (9th Cir. 2019)

This Court previously dismissed Plaintiffs' suit with prejudice, finding the two-year statute of limitations barred their claims. Order Granting Defendants' Motion to Dismiss with Prejudice, ECF No. 40. The Ninth Circuit disagreed. See Flynt, 940 F.3d at 462-63. Adopting the Sixth and Seventh Circuit's approach to the continuing violations doctrine, the Ninth Circuit found that "the continued enforcement of a statute inflicts a continuing or repeated harm" such that plaintiffs suffer a new injury each time they abstain from prohibited conduct. Id. Applying this doctrine, the Ninth Circuit found Plaintiffs' claims fell within the applicable limitations period. See id. 462-63.

On remand, Defendants filed another motion to dismiss.[1] Mot. to Dismiss ("Mot."), ECF No. 50. Plaintiffs oppose the motion. Opp'n, ECF No. 51; see also Defs.' Reply, ECF No. 52. For the reasons discussed below, the Court grants in part and denies in part Defendants' motion to dismiss. To the extent that Plaintiffs' dormant commerce doctrine claims rest upon the theory that California Business and Professions Code Sections 19858 and 19858.5 directly regulate or discriminate against interstate commerce, the Court dismisses them without prejudice. Plaintiffs lack standing to allege Sections 19858 and 19858.5 improperly discriminate against out-of-state investors. Moreover, their allegations that these provisions directly regulate interstate commerce fail as a matter of law. Plaintiffs

[1] This motion was determined to be suitable for decision without oral argument. E.D. Cal. L.R. 230(g). The hearing was scheduled for May 5, 2020.

do, however, adequately allege that Sections 19858 and 19858.5 indirectly regulate interstate commerce. To the extent that Plaintiffs' dormant commerce claims rests upon this theory of liability, the Court denies Defendants' motion to dismiss.

I. BACKGROUND

Subject to some restrictions, California permits in-state gambling. Specifically, it allows both residents and non-residents to operate cardrooms. Prospective cardroom owners must obtain a California gambling license, and renew it every two years, to operate within the state. Cal. Bus. Prof. Code § 19876(a). To avoid monetary and licensing penalties, California cardroom licensees must comply with California gambling laws. This case arises at the intersection of three of these state laws.

First, California prohibits cardrooms from engaging in casino-like activities (e.g., blackjack, roulette, and other house-banked or percentage games). Cal. Penal Code § 330. Second, California prohibits a person from "hold[ing] a state gambling license to own a gambling establishment if," among other things, he "has any financial interest in any business or organization that is engaged in any form of gambling prohibited by Section 330 of the Penal Code." Cal. Bus. & Prof. Code § 19858(a). This restriction applies to business investments "within [and] without [the] state." Id. Finally, California carves out a limited exception to § 19858's prohibition. See Cal. Bus. & Prof. Code § 19858.5. Section 19858.5 allows California cardroom licensees to hold up to a 1% financial interest in entities that host gambling prohibited by California

law, so long as the gambling is legal in the state where it occurs.

Flynt and the Kelegians are California residents who possess state-issued gambling licenses to operate card clubs in California. First Amended Compl. ("FAC") ¶¶ 8-10, ECF No. 32. Plaintiffs stand "ready, willing, and able to compete for the opportunity to invest in and/or operate out of-state-casinos," but Sections 19858 and 19858.5 limit their ability to do so. At various points since 2014, Plaintiffs have declined otherwise attractive business opportunities because the investments would cost them their California gambling licenses. FAC ¶ 4.

II. OPINION

To state a section 1983 claim, "a plaintiff must allege the violation of a right secured by the Constitution and laws of the United States, and must show that the alleged deprivation was committed by a person acting under color of state law." West v. Atkins, 487 U.S. 42, 48 (1988). Plaintiffs allege Defendants violated their rights to be free from California's regulation of, and discrimination against, interstate commerce. FAC ¶ 5. Defendants, however, maintain Plaintiffs failed to allege a cognizable theory of liability under the dormant commerce doctrine. Mot. at 5-10. Moreover, Defendants contend Kelegian, Jr.'s failure to exhaust his state administrative remedies bars his claim. Mot. at 14-15.

A. Exhaustion Requirement

California law provides that "[a]ny person aggrieved by a final decision or order of the commission that limits, conditions, suspends, or revokes any previously granted license"

may petition the Sacramento County Superior Court for review. Cal. Bus. & Prof. § 19932(a). "Under California law, exhaustion of administrative remedies is a jurisdictional requirement and 'absent a clear indication of legislative intent [a court] should refrain from inferring a statutory exemption from [the State's] settled rule requiring exhaustion of administrative remedies.'" City of Oakland, Cal. v. Hotels.com LP, 572 F.3d 958, 961 (9th Cir. 2009).

In 2014, the California Bureau of Gambling Control found that Kelegian, Jr. violated California's 1% rule. FAC ¶¶ 69-70, ECF No. 32. As a result, Kelegian, Jr. had to pay $210,000 in fines and assessments. FAC ¶ 71. Moreover, the state bureau required him to "refrain from any and all investment in out-of-state casino-style gambling facilities." FAC ¶ 71. Kelegian, Jr. did not petition for review of this decision.

Defendants argue this failure to exhaust administrative remedies precludes judicial review. Mot. at 14-15. Plaintiffs disagree, arguing Defendants waived their exhaustion argument by not raising it in their original motions to dismiss. Opp'n at 6 n.5. Neither argument controls. Rather, it is well-established that plaintiffs need not exhaust state administrative remedies before initiating a section 1983 suit in federal court. Knick v. Township of Scott, Pennsylvania, 139 S. Ct. 2162, 2167-68 (2019) (citing Patsy v. Bd. of Regents of State of Fla., 457 U.S. 496, 501 (1982)). The Court therefore declines to dismiss Kelegian, Jr.'s claims on this ground.

B. Dormant Commerce Doctrine

"The Commerce Clause of the United States Constitution

assigns to Congress the authority '[t]o regulate Commerce with foreign Nations, and among the several States.'" Sam Francis Foundation v. Christies, Inc., 784 F.3d 1320, 1323 (quoting U.S. Const. art. I, § 8, cl. 3) (modifications in original). This affirmative grant of authority to federal lawmakers contains an implied restriction on states' powers to regulate. Id. Courts refer to this limitation as either the dormant Commerce Clause or, more precisely, the dormant commerce doctrine. See id.; United States v. Durham, 902 F.3d 1180, 1203 (10th Cir. 2018). Imposing the dormant commerce doctrine's limits on state regulation is necessary to "ensure that state autonomy over 'local needs' does not inhibit 'the overriding requirement of freedom for the national commerce.'" Id. (quoting Great Atl. & Pac. Tea Co. v. Cottrell, 424 U.S. 366, 361 (1976)).

The dormant commerce doctrine prohibits two types of state lawmaking: (1) direct regulation of interstate commerce and (2) discrimination against interstate commerce. Daniels Sharpsmart, Inc. v. Smith ("Daniels"), 889 F.3d 608, 614 (9th Cir. 2018). "If a state statute 'directly regulates or discriminates against interstate commerce, or . . . its effect is to favor in-state economic interests over out-of-state interests,' it is 'struck down . . . without further inquiry.'" Chinatown Neighborhood Ass'n v. Harris, 794 F.3d 1136, 1145 (9th Cir. 2015) (quoting Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 579 (1986)).

If, however, a state statute "regulates evenhandedly" and "has only indirect effects on interstate commerce," courts proceed to ask whether those indirect effects "impose[] a

'significant burden on interstate commerce.'" Id. at 1146. If not, Ninth Circuit precedent "preclude[s] any judicial 'assessment of the benefits of [a state] law[] and the . . . wisdom in adopting' it." Id. (quoting Nat'l Ass'n of Optometrists & Opticians v. Harris, 682 F.3d 1144, 1156 (9th Cir. 2012)) (modifications in original). But if the statue imposes a "significant burden" on interstate commerce, courts must weigh that burden against the law's intrastate benefits. See Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970). Chinatown Neighborhood Ass'n, 794 F.3d at 1145-46. A state law will survive "Pike balancing" so long as the burden it imposes on interstate commerce is not "clearly excessive in relation to the putative local businesses." Pike, 397 U.S. at 142.

1. Discrimination Against Interstate Commerce

Within the context of the dormant commerce doctrine, "discrimination simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." United Haulers Assoc., Inc. v. Oneida-Herkimer Solid Waste Mgt. Auth., 550 U.S. 330, 338 (2007) (internal quotations omitted). A statutory scheme can discriminate against out-of-state interests in three ways: facially, purposefully, or in effect. Nat'l Ass'n of Optometrists & Opticians LensCrafters, Inc. v. Brown, 567 F.3d 521, 525 (9th Cir. 2009). Although Plaintiffs contend an earlier iteration of Section 19858 was discriminatory on its face, they do not allege that the law in its current form is facially discriminatory. Correctly so. California law prohibits both residents and non-residents with California

cardroom licenses from owning more than a 1% interest in casino-style gambling entities. Cal. Penal Code § 330; Cal. Bus & Prof. Code §§ 19858, 19858.5 The text of these provisions does not discriminate.

Plaintiffs do, however, argue that the purpose and effect of these laws are discriminatory. See Opp'n at 9-11; FAC ¶¶ 3, 5.a, 6, 26, 29, 41, 44-45. The complaint alleges that state officials, including former-Governor Gray Davis have said that Section 19858 was "primarily [] intended to prohibit out-of-state gambling interests from owning cardrooms in California." FAC ¶ 45. Plaintiffs argue discovery will show that "the only businesses that would be interested in obtaining [California] cardroom licenses are indeed casinos." Opp'n at 11. If true, the laws serve as a barrier to all out-of-state competition with in-state cardrooms. Id. But this injury does not align with the injury Plaintiffs claim.

The standing doctrine's "'injury in fact' test requires more than an injury to a cognizable interest. It requires that the party seeking review be himself among the injured.'" Lujan v. Defenders of Wildlife, 504 U.S. 555, 563 (1992) (quoting Sierra Club v. Morton, 405 U.S. 727, 734-735 (1972)). Plaintiffs are California residents with California gambling licenses. Their alleged injury is that California law prevents them from substantially investing in out-of-state casinos while retaining their licenses. See FAC ¶¶ 72, 75. Plaintiffs are not out-of-state casinos barred from procuring a California gambling license and competing with local cardrooms. They therefore lack standing to allege discrimination on an out-of-

state investor's behalf. See Lujan, 504 U.S. at 563; see also RK Ventures, Inc. v. City, 307 F.3d 1045, 1056 (9th Cir. 2002) (addressing the issue of standing sua sponte). To the extent that Plaintiffs' dormant-commerce claim rests on this theory of liability, the Court grants Defendants' motion to dismiss.

2. Direct Regulation of Interstate Commerce

"Direct regulation [of interstate commerce] occurs when state law directly affects transactions that take place across state lines or entirely outside of the state's borders." Daniels, 889 F.3d at 614. States cannot enact laws that "directly control[]" commerce occurring "wholly outside" the state's boundaries. Id. (quoting Healy v. Beer Inst., 491 U.S. 324, 336 (1989)). State laws that regulate extraterritorially are per se invalid under the dormant commerce doctrine, "regardless of whether the statute's extraterritorial reach was intended by the legislature." Id.

In determining whether a state statute directly regulates out-of-state business, "[t]he critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the state." Healy, 491 U.S. at 336. Plaintiffs contend their extraterritorial-regulation argument directly mirrors the one recognized in Daniels, 889 F.3d at 615-616. Daniels addressed a medical waste handler's dormant commerce challenge to the California Medical Waste Management Act (MWMA). Id. at 612. Plaintiff sought and obtained a preliminary injunction against the Department's MWMA enforcement. Id. at 613. The Ninth Circuit upheld the injunction. In doing so, it found Plaintiff was likely to

succeed on his claim that the Department's extraterritorial application of the MWMA violated the dormant commerce doctrine. Id. at 615-616.

But Daniels is not a perfect match for this case. In Daniels, the Ninth Circuit found itself "faced with an attempt to reach beyond the borders of California and control transactions that occur wholly outside of the state after the material in question . . . ha[d] been removed from the state." Id. at 615. Put simply: the state was regulating activity it had no business regulating. Sections 19858 and 19858.5 do not, however, regulate conduct that is wholly unrelated to, or occurs wholly outside of, the state. These provisions regulate the ownership of cardrooms within California's borders and prevent illegal gambling interests from becoming too intertwined with legal gambling operations. These provisions have extraterritorial effects, such as requiring Plaintiffs to restructure out-of-state business deals or forego them entirely. See FAC ¶¶ 49-77. But extraterritorial effects do not render a law per se invalid if those effects "result from a regulation of in-state conduct." Chinatown Neighborhood Ass'n, 794 F.3d at 1145-46 (collecting cases). Sections 19858 and 19858.5's out-of-state consequences flow from California's valid regulation of its in-state cardrooms.

Plaintiffs argue this case differs from cases like Chinatown Neighborhood Ass'n and Nat'l Ass'n of Optometrists & Opticians LensCrafters, Inc. v. Brown where the Ninth Circuit upheld state statutes with extraterritorial effects. Opp'n at 8-9. Specifically, they argue the laws upheld in those cases

did not bar California residents from going to another state and engaging in business that was lawful outside California. This argument misgauges the scope of Sections 19858 and 19858.5. Plaintiffs do not allege these provisions restrict all California residents from investing in out-of-state casinos. Nor do Plaintiffs allege these laws prevent all California residents from owning casinos in states where casino-style gambling is lawful. California law only restricts these business practices when they intersect with the ownership or operation of a card club located in California.

Finally, Plaintiffs argue Sections 19858 and 19858.5 impermissibly regulate wholly out-of-state conduct because "the Statutes' effect is not only on the cardroom licensees, but instead, applies to all of the licensee's partners, officers, directors, and shareholders, regardless of their location." Opp'n at 8 (citing FAC ¶¶ 26, 57-63) (emphasis in original). The Court declines to address the merits of this argument. To sufficiently allege a facial challenge, a plaintiff "must establish that no set of circumstances exist under which the Act would be valid." United States v. Salerno, 481 U.S. 739, 745 (1987). Plaintiffs therefore had to allege Sections 19858 and 19858.5 directly regulated interstate commerce with respect to licensees and non-licensees. As previously discussed, Plaintiffs fail to allege Sections 19858 and 19858.5 directly regulate interstate commerce with respect to California cardroom licensees. The laws' application to non-licensees cannot, in itself, revive Plaintiffs' facial challenge. Nor can it serve as the basis for an as-applied challenge. Plaintiffs, as

licensees, lack standing to challenge Sections 19858 and 19858.5 on non-licensees' behalf. Lujan, 504 U.S. at 563.

The Court finds Plaintiffs lack a cognizable legal theory for their claim that Sections 19858 and 19858.5 directly regulate interstate commerce. To the extent that Plaintiffs' dormant commerce claims rest upon a direct-regulation theory, the Court grants Defendants' motion to dismiss.

3. Indirect Regulation of Interstate Commerce

A state's evenhanded regulation of intrastate activity will nonetheless violate the dormant commerce doctrine if its indirect effects on interstate commerce impose a "significant burden" that is "clearly excessive in relation to the putative local benefits." Pike, 397 U.S. at 142; Nat'l Ass'n of Optometrists & Opticians v. Harris, 682 F.3d at 1156-57.

Plaintiffs allege Sections 19858 and 19858.5 impose a significant burden on interstate commerce in two respects. First, the State's 1% rule not only prevents Plaintiffs from substantially investing in casino-style gambling; it also prevents Plaintiffs from doing business with anyone who has substantial investments in casino-style gambling. FAC ¶ 83. As enforced, this restriction all but completely bars California cardroom licensees from investing in out-of-state gambling ventures. Opp'n at 12-13. Second, the laws restrict Plaintiffs' ability to invest in businesses unrelated to gambling. Flynt, for example, owns an out-of-state "exotic dance establishment." FAC ¶ 83. If Flynt's business partner independently invests in a Nevada casino, Flynt will have to divest his interest in the dance club—even though the dance club itself does not host

gambling that is illegal under California law. Id. Plaintiffs argue Sections 19858 and 19858.5's ability to regulate industries unrelated to gambling adds to the significance of their burden on interstate commerce. Opp'n at 3.

Plaintiffs contend these burdens are "clearly excessive" in relation to California's claimed interest in crime prevention—namely because this interest no longer exists. FAC ¶ 85. They allege state officials on both sides of the political spectrum have repudiated the notion that Sections 19858 and 19858.5 are still necessary to prevent crime. FAC ¶¶ 39, 44-46. That the State has exempted various cardrooms from complying with the 1% rule only further undermines this putative benefit. See FAC ¶¶ 28, 36, 40-41. Defendants fail to illustrate how these allegations are insufficient as a matter of law. To the extent that Plaintiffs' dormant commerce doctrine claims rest upon an indirect-regulation theory of liability, the Court denies Defendants' motion to dismiss.

III. ORDER

For the reasons set forth above, the Court GRANTS IN PART and DENIES IN PART Defendants' motion to dismiss. To the extent that Plaintiffs' dormant commerce doctrine claims rest upon the theory that Sections 19858 and 19858.5 directly regulate or discriminate against interstate commerce, the Court DISMISSES them WITHOUT PREJUDICE. Plaintiffs lack standing to allege Sections 19858 and 19858.5 improperly discriminate against out-of-state investors. Moreover, their allegations that these provisions directly regulate interstate commerce fail as a matter of law. Plaintiffs do, however, adequately allege that Sections

19858 and 19858.5 indirectly regulate interstate commerce. To the extent that Plaintiffs' dormant commerce claims rests upon this theory of liability, the Court DENIES Defendants' motion to dismiss.

If Plaintiffs amend their complaint, they shall file an Amended Complaint within twenty (20) days of this Order. Defendants' responsive pleading is due twenty days thereafter.

IT IS SO ORDERED.

Dated: June 12, 2020

JOHN A. MENDEZ,
UNITED STATES DISTRICT JUDGE