



Beverage Alcohol Brief

Recent developments in beverage alcohol law

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The Commerce Clause and the three-tier system: Advances in direct wine shipping

By *Kate J. Hardy and Robert K. Carrol*

In a significant decision for interstate wine retailers, the U.S. District Court of Eastern Michigan ruled on September 30 that the provisions of the Supreme Court's 2005 decision in *Granholm v. Heald* apply to retailers, meaning that Michigan's ban on wine shipments direct to consumers from out-of-state retailers constitutes site-based discrimination and is unconstitutional. This is the second such ruling this year; the first was a U.S. District Court ruling on a similar law in Texas.

In *Granholm*, the Supreme Court declared that it was unconstitutional for states to create site-based discrimination between in-state wineries and out-of-state wineries in the sale of wine direct to consumers. Legislation in both New York and Michigan was held to contravene the Commerce Clause by allowing domestic wine producers to ship to customers in the state, but preventing interstate producers from doing so. Each of these states had created laws bypassing the three-tier system to assist in-state interests in accessing consumers directly without going through the wholesale and retail tiers.

Following that decision, these and the many other states that had similar legislation were forced to make a choice: Either allow all wineries to ship to consumers or prevent even in-state wineries from doing so. In most cases, the market was opened to all wineries. In a number of cases, the legislature introduced creative measures, such as total production volume caps and mandatory consumer visits to the winery, to restrict the eligibility of wineries to direct ship. In a recent development, on October 24, the Court of Appeals for the Sixth Circuit in Tennessee gave its decision in *Jeloušek v. Bredesen*. It held that the local law was discriminatory in that, among other things, it gave only producers using 75-percent locally grown grapes the right to ship directly to consumers. There are also currently pending actions in states, including Arkansas, Delaware, Indiana, Kentucky, Maine, Massachusetts, New Jersey, and Pennsylvania.

Despite the fairly broad language used by the Supreme Court, where the majority opinion speaks of discrimination against “shippers,” the approach generally was to make changes only where wineries were concerned, as that was the limit of the legislation that had been enacted. Generally speaking, the states did not appear to consider the case as having any broader impact than on wineries, and similar restrictions concerning retailers were largely unchanged.

Fast-forward nearly four years and the same governor in Michigan is in court again, defending legislation in the case of *Siesta Village Market v. Granholm*. This time, the challenge was brought by an out-of-state retailer against protectionist legislation, allowing in-state retailers to ship to consumers but creating additional burdens for out-of-state retailers in doing the same. In a decision handed down by Judge Hood in the Eastern District Federal District Court, the plaintiff was successful in its motion for summary judgment against the state and the discriminatory legislation was held to be unconstitutional under the Commerce Clause. The judge ordered the state to cease its prohibition of out-of-state sales and to stop enforcing any of the provisions of the law against out-of-state retailers.

Before the decision, only Michigan retailers were able to ship wine directly to consumers once they were licensed as a “specially designated merchant” (SDM). An out-of-state retailer was not allowed to ship to Michigan consumers unless it established a physical presence in Michigan (thus becoming an in-state retailer) and obtained an SDM license. The judge found that these requirements were burdensome on out-of-state retailers because of the many costs associated with opening a new location in the state. The state’s arguments that allowing direct shipment by out-of-state retailers would make it difficult to collect taxes and control labeling were rejected.

Across the country, 31 states allow retailers to ship direct to consumers, but only 13 of them allow an out-of-state retailer the same privilege (not including Michigan). This second *Granholm* decision is one of three challenges that have now been decided among a crop of retailer suits brought following the first landmark *Granholm* case. It builds on and follows the result in the matter of *Siesta Village Market v. Perry*, brought by the same Florida retailer in the state of Texas, and decided in January of this year. That court also ruled that the challenged legislation was unconstitutional, but created some confusion when it still required an out-of-state retailer to buy from an in-state wholesaler. The *Perry* court specifically elected not to follow the first decided retailer challenge in New York of *Arnold’s Wines, Inc. v. Boyle*. In that case, the court held that the out-of-state retailer’s challenge was a direct challenge to the three-tier system itself and that the 21st Amendment rights of the states circumvented the Commerce Clause. It thus accepted the resulting discrimination as constitutional.

Both *Arnold’s Wines* and *Perry* are under appeal to their respective circuits and the Michigan Attorney General has also now filed notice saying that the latest *Granholm* decision will also be appealed. It will, however, be some time before we see whether the Supreme Court will weigh in on this issue.

Despite the current trend of acceptance of direct shipping, none of the decisions referenced in this article should be seen as challenging the inherent acceptance of the three-tier system and the 21st Amendment. Indeed, the Supreme Court in *Granholm* was very supportive of the continuing relevance of the three tiers in the control of alcohol distribution. It is the states that are opening these doors. By creating exceptions to the tiers for their domestic economic interests, they have come into conflict with the Commerce Clause and have had to extend direct shipping rights to interstate interests as well.

Notwithstanding, with wineries and, increasingly, retailers being able to ship direct to consumers in many states, the question becomes why importers and foreign wineries are not also benefiting from these increased markets. For example, a French wine producer cannot ship direct to a consumer in New York in the same way as his U.S. competitors. Even his importer—a U.S. company with all the appropriate licenses—cannot ship direct to consumers. That producer has no option but to go through the three tiers to gain access to consumers. Not only does this potentially raise Commerce Clause issues within this country, but it also suggests problems at World Trade Organization (WTO) level in the creation of technical barriers to free and equal trade. This, indeed, likely signals the potential future direction of challenges to the unequal treatment of the various players in the beverage alcohol industry that we are seeing now.

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MEMORANDUM

Date: November 5, 2008

To: Doug Caskey

From: Bill Nelson
Cary Greene

Re: Summary of Recent Court Opinions and Some Policy Analysis

Courts in numerous states dealt with direct shipment and self-distribution this year:

1. Arizona. In February, an Arizona federal District Court held constitutional both facially neutral production caps as a qualification for direct shipper licensing, as well as face-to-face purchase requirements as a precondition to direct shipment.
2. Indiana. In August, the Seventh Circuit Court of Appeals held constitutional face-to-face purchase requirements as a precondition to direct shipping, but struck down as unconstitutional a limitation in Indiana's law that prohibited out-of-state wineries permitted to self-distribute in their home state from acquiring direct shipper licensing.
3. Michigan. In September, a Michigan federal District Court held unconstitutional a restriction that prohibited out-of-state retailers from shipping to local consumers where the state allowed local retailers to make such shipments.
4. New Jersey. In June, a New Jersey federal District Court held constitutional a complete ban on direct-to-consumer shipments by both in-state and out-of-state wineries, but struck down as unconstitutional New Jersey's licensing fee structure and satellite tasting room limits. The court believed that New Jersey discriminated against out-of-state wineries by charging them higher licensing fees and allowing them fewer satellite tasting rooms than local wineries.
5. Tennessee. In October, the Sixth Circuit Court of Appeals held constitutional a complete ban on direct-to-consumer shipments by both in-state and out-of-state wineries, but questioned the constitutionality of (1) minimum local fruit requirements, (2) licensing residency requirements, and (3) personal transportation limits (i.e., how much wine a customer may take home). The court sent the case back to a Tennessee federal District Court for further proceedings, and gives the state of Tennessee an opportunity to justify the challenged laws, and local wineries an opportunity to intervene to defend their rights.

6. Texas. In January, a Texas federal District Court held unconstitutional a restriction that prohibited out-of-state retailers from shipping to local consumers where the state allowed local retailers to make such shipments. The decision required out-of-state retailers to purchase wine through the Texas three-tier system prior to shipping wine to Texas consumers.

There are also several pending cases where decisions are expected to be issued soon:

7. Kentucky. A Kentucky federal District Court held constitutional facially neutral production caps as a qualification for direct shipper licensing (prohibiting wineries over 50,000 gallons from obtaining a license) and per visit purchase limitations (allowing customers to buy up to 2 cases per visit), but struck down face-to-face purchase requirements as a precondition to direct shipping because, although facially neutral, the requirements served as a practical barrier to shipments from out-of-state wineries. The question of the constitutionality of face-to-face purchase requirements was appealed by Kentucky's wholesalers to the Sixth Circuit Court of Appeals in January 2007.

8. Massachusetts. In July 2008, a Massachusetts federal District Court heard cross-motions for summary judgments concerning the constitutionality of the state's facially neutral production caps as a qualification for direct shipper licensing (prohibiting wineries over 30,000 gallons from obtaining a license), but has yet to issue a decision.

A. More About Tennessee

In a recent newsletter article (WineAmerica November 2008 newsletter), we provided a basic outline of the Tennessee courts decision.

“In the Tennessee decision, the Sixth Circuit Court of Appeals identified at least three problems with the Tennessee Grape & Wine Law. *First*, the court indicated that requiring wineries to use a minimum amount of local fruit in order to qualify for tasting room and other privileges unfairly favored local interests. *Second*, the court indicated that requiring wineries to be Tennessee residents for at least two years merely to qualify for a winery license also unfairly favored local interests. *Third*, the court raised concerns about the legality of restrictions on the amount of wine an individual may personally transport across Tennessee state lines where no similar restrictions are imposed on intrastate personal transportation. The court sent the case back to a federal District Court in Tennessee for further proceedings. The decision gives the state of Tennessee an opportunity to justify the challenged laws, and local wineries an opportunity to intervene to defend their rights. . . .

“If more of these opinions trickle out, winery rights may be slowly and unevenly eroded. This, in turn, could make legislators less willing to work to ensure a favorable marketing climate for in-state wineries. Should this erode winery opportunities, wineries will face an uphill battle for survival in some states.”

A copy of the complete article is attached to this summary. We have also conducted some analysis of the constitutional concerns raised by the Sixth Circuit Court of Appeals. A quick sketch is as follows:

1. Local Fruit Requirements. The *Jelovsek* decision identifies relevant Supreme Court precedent that appears to disfavor local fruit mandates on dormant Commerce Clause grounds.

See slip op. at 5-6 (citing *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 265, 270-271 (1984)) (stating that laws “granting benefits to fruit wine manufactured in the State from products grown in the state [and] intended to help in stimulating the local fruit wine industry” were unconstitutional). If arguments can be found to contradict the Sixth Circuit, or to otherwise justify the local fruit requirement, we believe it would be beneficial to at least have the option of establishing local fruit requirements, rather than having the option taken off the table by courts.

2. Residency Restrictions. Even if there were arguments constitutionally supporting residency restrictions – which appears unlikely given that the core function of the Supreme Court’s dormant Commerce Clause jurisprudence is to avoid “economic protectionism” – seeking investment from non-residents, including non-resident corporations might benefit Tennessee wineries. See, e.g., *id.* at 3 (“The modern law of what has come to be called the dormant Commerce Clause is driven by concern about economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.”) (citations omitted).

3. Personal Transport Limitations. In accordance with the Twenty First Amendment of the Constitution, “transportation or importation into any State, Territory, or possession of the United States for delivery or use therein” must be in accordance with state law. U.S. Const. amend. XXI, § 2. Personal import limits for wines transported into Tennessee appear to fall within this provision. As the Fourth Circuit Court of Appeals has explained, a “Personal Import Exception is not economic protectionism. . . . It provides a *de minimis* exception to [a state’s] import regulations [*i.e.*, the three-tier system], allowing consumers to import . . . wine for personal consumption. Under no economic construct could such a provision be considered economic protectionism of industry.” *Brooks v. Vassar*, 462 F.3d 341 (4th Cir. 2006). For these reasons, we believe that the Tennessee wineries would appear to be on firm constitutional ground arguing in favor of Tennessee’s personal transportation laws.

While the *Jelovsek* decision raises constitutional concerns, it reserves final judgment pending further justification from Tennessee and the Tennessee wineries. Absent such additional justification, and barring a District Court opinion, it is difficult to see how the Sixth Circuit’s opinion can be taken as precedent to suggest that the laws are currently unconstitutional.