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On Behalf of
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Hearing on H.R. 5034, the "Comprehensive Alcohol Regulatory Effectiveness Act of 2010"

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1. Introduction

I represent the Wine Institute, the public advocacy association of California wineries, which includes more than 1,000 wineries and affiliated businesses. Those wineries represent a vital sector of the United States economy. America's 6,700 wineries—the vast majority of which are small, family-owned farms—are responsible for more than $20 billion in sales in the U.S. and support more than 1 million American jobs. Wineries are important tourist destinations, attracting 27 million visitors annually and supporting other businesses such as hotels, restaurants and shops. With or without amendment, the passage of H.R. 5034 will greatly imperil this vibrant, dynamic agricultural industry.

Today, a winery seeking access to consumers in a state barring or restricting direct shipment of wine has only one real option—to obtain a wholesaler to distribute its products. Small and medium wineries are unlikely to find wholesalers willing to distribute their wines for two reasons. First, small and medium wineries cannot offer distributors sales volume comparable to that of the largest winemakers. Second, considerable consolidation has occurred in the wholesale tier in recent years. This means the vast majority of wineries face an increasingly narrow gauntlet of wholesalers. As the number of wineries has exploded, the number of wholesalers has dwindled. In 1998, there were approximately 1200 wine distributors nationwide.[1] By 2008, that number decreased by half to 600 distributors nationwide. Today's wine distribution system is shaped like an hour-glass, with thousands of producers at the top, and millions of consumers at the bottom, with only a few distributors between them. The top 10 US wine and spirits wholesalers dominate the market with 59% of the market share.[2] At the same time in the U.S., there were 84,000 Certificates of Label Approvals (COLAS) approved for wine alone in 2009.

To make matters worse, wholesalers tend to focus almost exclusively on the well-known, high-volume wines to the exclusion of the smaller, lesser-known brands.[3] Wholesalers ordinarily do little in exchange for the high costs they charge small and medium wineries. Not surprisingly, wineries that succeed in obtaining wholesalers often complain that the wholesaler fails to maintain contact with restaurants or wine shops after making an initial sales call. Some wineries learn that restaurants have stopped selling their wines because the wholesaler has told the restaurant the wine is unavailable even though the wholesaler actually has the wine in stock. As a result, wineries with wholesalers often find they must incur additional marketing expenses, further draining their narrow margins. In contrast, alcohol wholesalers exact margins that can exceed 30 percent and are far more profitable than the typical wholesaler, earning 66 to 83 percent more in profits than the typical wholesaler over a 10 year period.[4]

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[1] *See* SVB. 2008-2009 report.

[2] Impact Databank, April 1 and April 15, 2010.

[3] *See* Rob McMillan, *2010-2011 State of the Wine Industry* (2010) (available online at http://www.svb.com/2147483667/2010_-_2011_State_of_the_Wine_Industry_Report/) ("The large wholesale partners in the business locked themselves inside their castles last year and pretended they didn't know the small wine producer.").

[4] *See* Dun & Bradstreet, Industry Norms & Key Business Ratios.

For all these reasons, United States wineries have an interest in even-handed regulation permitting them to ship wine directly to consumers and retailers. The development of phone and internet sales provide them an opportunity for just that. But for similar reasons, United States alcohol wholesalers have an interest in maintaining their grip on the bottleneck between alcohol producers and alcohol retailers and consumers. H.R. 5034 is a piece of special interest legislation for the benefit of wine, beer, and spirits wholesalers at the expense of producers, retailers and consumers. As the free-market advocacy group FreedomWorks put it, H.R. 5034 "is a simple piece of economic protectionism, designed to shore up the monopoly earnings of wholesalers at the expense of everyone else."[5] While wholesalers have trumped up reasons why H.R. 5034 serves state and public interests, none of those reasons withstand scrutiny on the facts or the law.

2. <u>Regulation</u>

Where the alcohol industry is concerned, we live in a regulated world. A complex web of state and federal regulation governs, and will for the foreseeable future.

Ninety-nine percent of these regulations currently in place are legally secure. As the Subcommittee on Courts and Competition heard in March, when Pamela Erickson testified regarding her study of alcohol deregulation in the U.K., the United States is *not* in danger of following the U.K.'s bad example, because the United States has a comprehensive, carefully balanced system of alcohol regulation at both the federal and state levels. Congress has delegated power to regulate alcohol to the federal government, in particular the Department of the Treasury. In addition, states have robust regulatory power under the Twenty-First Amendment.

The centerpiece of federal regulation of alcohol is the Federal Alcohol Administration Act, or FAAA. The FAAA establishes federal permit requirements for the manufacture, shipment, and sale of most alcoholic beverages. It also imposes special prohibitions on unfair and anticompetitive trade practices in the alcohol market, and creates labeling requirements for alcoholic beverages. In addition, other domains of federal regulation apply equally to the alcohol market. Antitrust law, for example, applies to alcohol markets, and the Supreme Court has prevented states from enabling in-state cartels and monopolies in the alcohol market. Lastly, there is the 21st Amendment Enforcement Act, which authorizes state attorneys general to seek injunctive relief in federal court for violations of their states' alcohol regulations. 27 U.S.C. § 122a.

Few would argue that federal regulations such as these are not sound public policy. Can you imagine what would happen to American wine and beer commerce if every state had different and contradictory labeling requirements? These federal regulations are uncontroversial and unchallenged.

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[5] *See* Wayne T. Brough, *No Wine Shall Be Served Before Its Time—At Least Not Without Wholesalers Taking A Cut* (FreedomWorks Issue Analysis No. 128, 2010).

Meanwhile, states impose regulations of their own. Every state has an alcoholic beverage code. Combined, states enforce nearly 4,000 alcohol laws today. Most states have adopted a "three-tier system" in which alcohol production, wholesale, and retail are separately licensed and strictly separated into different market segments. All states license the alcohol producers, wholesalers, and retailers authorized to do business in-state, and regulate (or even prohibit) direct shipping of alcohol. States are permitted to prohibit tied houses, keep alcohol from minors, impose alcohol taxes, or take direct control of liquor distribution through state-run stores.

Importantly, 37 states and the District of Columbia have struck an appropriate balance between robust alcohol regulation and consumer market access. In 1997, the Model Direct Shipment Bill was approved by the National Conference of State Legislatures' Task Force on the Wine Industry. This even-handed alcohol regulation requires licenses for interstate wine shipment and requires adult signatures on all wine deliveries. These laws require that licensees submit to the jurisdiction of the destination state and file monthly reports regarding type and quantity of shipments entering the state. Some restrict the number of cases of wine allowed in each state. To date, no state legislature has repealed this kind of permit.

State alcohol regulations such as these are guaranteed by the Constitution itself, in the Twenty-First Amendment. Alcohol is the only article in American commerce with its own special constitutional provision, and what that provision says is that states have the right to regulate transport of alcohol across their borders and to structure their internal alcohol markets. The Webb-Kenyon Act and the Wilson Act, the two century-old federal statutes that H.R. 5034 would amend, reinforce that right. The Twenty-First Amendment is safe. Nothing has happened since its enactment to detract from it. In fact, in 2000 Congress took a close look at the Twenty-First Amendment and the field of state alcohol regulation. Congress had the opportunity then to conclude that states' Twenty-First Amendment powers needed additional protection or extension, but decided they did not. In enacting the 21st Amendment Enforcement Act, mentioned earlier, Congress only granted states a federal forum, but made that forum available only for cases that were consistent with a valid exercise of state power as interpreted by the Supreme Court, including interpretations in conjunction with other provisions of the Constitution, and expressly stated that the Act "shall not be construed to grant to States any additional power." 27 U.S.C. § 122a(e). Although Congress enacted the 21st Amendment Enforcement Act in 2000, no state has ever taken advantage of the federal court forum it provides, because they have never needed to. Nothing has changed since 2000 to change Congress's conclusion. The Twenty-First Amendment is, in other words, alive and well. The rumors of its death you may have heard from the wholesalers are greatly exaggerated.

It is only discriminatory and anti-competitive alcohol regulations that are an issue. The Federal Trade Commission has now twice concluded that discriminatory state alcohol regulations detract from consumer welfare with no benefit. In 2003, the FTC concluded that state limits on the ability of consumers to order wine shipments by mail, phone, or the internet are anticompetitive and harm consumers, and that they are not necessary to serve positive goals such as keeping alcohol from minors.[6] And just this summer, an FTC working paper analyzed

[6] *See* FTC, *Possible Anticompetitive Barriers to E-Commerce: Wine* (2003).

certain state alcohol regulations, in particular "post and hold" laws requiring alcohol wholesalers to post their prices in advance and maintain them for a certain period of time, and reached some striking conclusions.[7] First, the paper found that monopoly protection laws lead to higher prices and reduced consumer welfare. Second, it actually discussed the pre-amendment version of H.R. 5034, and concluded "that constraining antitrust enforcement through the proposed legislation would result in lower consumer welfare for alcoholic beverage consumers with no offsetting reduction in social harms." [8]

3. <u>Litigation</u>

Contrary to the "sky is falling" de-regulation rhetoric advanced by wholesalers, the only state alcohol regulations that are truly vulnerable in court today are ones that discriminate against out-of-state businesses.

Commerce Clause challenges are actually not common, but they are vital to the American economy, and even to the union itself. The Framers of the Constitution created this country as a *single* economic union. As Justice Cardozo put it, "the peoples of the several states must sink or swim together[.]" *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511 (1935). When a state discriminates against out-of-state businesses without justification, Congress should *want* that discrimination invalidated. Such statutes are a blow to the economic union of the fifty states; in fact they undermine our federal system. To put it bluntly, the rule against economic nondiscrimination among the states prevents inter-state trade wars. To characterize the invalidation of such statutes as an assault on state regulatory prerogatives is simply wrong.

The Commerce Clause applies to items and entities in the stream of interstate commerce. In virtually all successful Commerce Clause challenges to state alcohol laws, a state legislature has afforded in-state alcohol market participants a competitive advantage or benefit, but has not extended that privilege to out-of-state alcohol market participants. Importantly, the state legislature has already performed a public policy analysis regarding the public health and safety consequences of conferring the privilege. The constitutional problem arises when the legislature chooses to confer it without providing a level playing field for out-of-state entities. Under the Commerce Clause, states must either "level up" or "level down," that is, extend the privilege to all similarly situated alcohol market participants or none at all.

Granholm v. Heald, 544 U.S. 460 (2005), is the Supreme Court's most recent major pronouncement on how the Commerce Clause interacts with the Twenty-First Amendment. In that case, the Supreme Court struck down discriminatory laws from Michigan and New York. Notwithstanding the power states have under the Twenty-First Amendment, *Granholm* establishes that the Commerce Clause's nondiscrimination principle is binding on them. Just as the Twenty-First Amendment does not justify violations of federal statutes or other constitutional provisions, it "does not abrogate Congress' Commerce Clause powers with regard to liquor." *Id.*

[7] *See* James C. Cooper & Joshua D. Wright, *State Regulation of Alcohol Distribution: The Effects of Post & Hold Laws on Consumption and Social Harms* (FTC Working Paper No. 304, 2010).
[8] *Id*. at 25.

Under *Granholm* and other Supreme Court cases, the existing Commerce Clause standard for challenges to state alcohol regulations is essentially as follows. A state may not enforce a law that discriminates against out-of-state economic actors, including alcohol market participants, in any of the following ways. First, some state laws are "facially discriminatory," that is, they apply to companies differently depending on where they are located. The Supreme Court stated in *Granholm* that under the Commerce Clause, when state alcohol regulations are facially discriminatory, they must be struck down unless they serve a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. The Supreme Court found that Michigan could regulate out-of-state wine shipments without discriminating against non-resident producers or shippers. The Supreme Court embraced the Model Direct Shipment Bill as a non-discriminatory alternative and struck down Michigan's facially discriminatory wine shipping law.

Second, and critical to the analysis of H.R. 5034, in *Granholm* the Court invalidated a "facially neutral" New York statute that created an in-state presence requirement for wineries wishing to ship directly to New York consumers. The law required all New York-licensed wineries to open branch offices in-state. Similar in-state presence or ownership requirements have been struck down in *Cooper v. McBeath*, 11 F.3d 547 (5th Cir. 1994), and *Southern Wine & Spirits v. Steen*, 486 F. Supp. 2d 626 (W.D. Tex. 2007). Many other kinds of statutes also discriminate without doing so facially. In *Family Winemakers v. Jenkins*, 592 F.3d 1 (1st Cir. 2010), the United States Court of Appeals for the First Circuit struck down a Massachusetts statutory exemption permitting direct shipments of wine by "small wineries" while prohibiting direct shipment by medium and large wineries—all of which happened to be from out-of-state. In *Baude v. Heath*, 538 F.3d 608 (7th Cir. 2008), the Seventh Circuit struck down an Indiana law which prohibited wineries from holding wholesale licenses, a statute which had the effect of preventing of out-of-state wineries from shipping directly to Indiana consumers while allowing all wineries in Indiana to do so. In *Cherry Hill Vineyards, LLC v. Lilly*, 553 F.3d 423 (6th Cir. 2008), the Sixth Circuit struck down a Kentucky statute that imposed a first time mandatory winery visit requirement that made it "financially infeasible for out-of-state wineries to sell directly to Kentucky residents." Each of these statutes constituted economic protectionism harmful to out-of-state business, and ultimately to consumer welfare as well. If H.R. 5034 passes, these discriminatory statutes that harm an already stressed industry will be immunized from Commerce Clause challenge.

These laws were challenged on the basis of discriminatory *purpose and effect.* Identifying a legislature's purpose is challenging, but courts do so by reading the statute as a whole and considering how the practical operation impacts out-of-state businesses. Perhaps the statute includes a statement of purpose; if so, courts consider whether the statute is tailored to achieve it. Courts look at the statute's history as well. Relevant history might include, for example, statements by legislators during the statute's drafting and enactment, or the place of the statute in the development of the state's laws over time. These were among the factors that the First Circuit considered in striking down the discriminatory Massachusetts statute.

Courts usually avoid striking down statutes for discriminatory purpose alone, in the absence of discriminatory effect. When a court finds both that the statute has discriminatory effect and that the legislature had a discriminatory purpose, unsurprisingly the court is much less deferential. *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984); *Hunt v. Wash. State Apple Adver. Comm'n*, 432 U.S. 333 (1977). In *Bacchus*, for example, the Supreme Court found that because the state of Hawaii had discriminated in purpose and effect, its regulations were subject to a strict scrutiny standard. In other words, when a statute is not facially discriminatory but has discriminatory effect, a finding of discriminatory purpose weighs strongly for invalidation. Similarly, in *Family Winemakers*, the First Circuit Court of Appeals struck down a state statute finding substantial evidence of discriminatory purpose that had the effect of excluding 98 percent of the United States wine market from shipping directly to Massachusetts consumers. Congress should applaud that result as well.

H.R. 5034 substitutes a new more intrusive standard for courts to evaluate "facially neutral" statutes under the Commerce Clause. In place of the current standard that focuses on multiple factors to determine whether a statute is discriminatory in purpose and effect, this bill calls for a narrow, intrusive inquiry into what state legislators "intended" at the time a state alcohol regulation was passed. This is both highly speculative to prove and extremely difficult for Courts to divine. Today, as explained above, a statute's purpose is thoroughly examined through a broad investigation of its context and circumstances. In contrast, H.R. 5034 confines courts to a narrow, "second guessing" like probe into legislative intent.

Further, the proposed amendments to H.R. 5034 do not indicate the nature of the evidentiary burden necessary to prove legislative intent. Under the current framework, the burden on plaintiffs to show discriminatory purpose and effect is quite heavy: The First and Ninth Circuits have said a plaintiff's evidence must be "substantial." Often plaintiffs challenging state regulations fail to produce evidence that they have been harmed, for example in a recent case in the Ninth Circuit involving Arizona regulations. *Black Star Farms LLC v. Oliver*, 600 F.3d 1225 (9th Cir. 2010). It is rare that a state statute is struck down on that basis alone. As a result, the statutes now struck down on the basis of discriminatory effect alone are particularly flagrant ones. Disrupting the current framework with H.R. 5034's intrusive "intent" standard and ill-defined evidentiary burden will only create confusion and generate additional litigation.

Because Congress and the Commerce Clause already leave states vast regulatory discretion, and because the framework for scrutiny of state alcohol regulation adopted by the Supreme Court in *Granholm* has proved workable in practice, there is actually very little current litigation over those state alcohol laws. The supporters of H.R. 5034 have told you that the state system of alcohol regulation is threatened by an onslaught of litigation seeking to invalidate state alcohol regulations. Our response is, quite simply: What onslaught? There is none.

The total number of cases challenging state alcohol regulations in the five years since *Granholm* has been small. We have identified only about two dozen cases in that time frame involving such challenges. Not all of those cases relate to the Commerce Clause in the first place, and it is specifically Commerce Clause challenges that H.R. 5034 purports to address. Some of the cases that have been filed were actually filed by wholesalers, the same businesses now pressing H.R. 5034 as a defense to excessive litigation. Furthermore, the number of cases has been declining. Today, there are only three such cases pending. Thirty-two of the fifty states have seen no new litigation in the wake of *Granholm*. Considering how little litigation has occurred, the argument that Commerce Clause litigation poses a financial burden for states falls flat. If anything, H.R. 5034 is the true harbinger of new waves of expensive litigation.

Currently, courts give state alcohol regulations great deference. And, plaintiffs must meet a heavy burden in Commerce Clause challenges. Congress need not enact any further federal legislation in this area.

<u>The Real Story of H.R. 5034</u>

The fact is that H.R. 5034 is not about protecting the overwhelming majority of state alcohol regulations at all. Tellingly, the National Association of Attorneys General takes **no** position on this bill. Instead, H.R. 5034 is about protecting wholesalers from competition. It is nothing less than a power grab designed to protect their market share. What wholesalers want is the opportunity to develop in-state cartels, free from competition from out-of-state wineries, breweries, retail outlets, and other wholesalers. H.R. 5034 would give the wholesalers just that.

Critically, the Bill sweeps away the existing Commerce Clause standards that protect the American union from states discriminating against businesses from other states. The Commerce Clause now provides a comprehensive range of protections related to product and entities in interstate commerce, H.R. 5034 would permit only one type of challenge, protecting one type of entity. It preserves challenges against statutes that intentionally or facially discriminate against out-of-state alcohol *producers*. But, it gives states free reign to pass intentionally and facially discriminatory statutes that foreclose out-of-state wholesalers and retailers from market access.

Even as to producers, states could escape H.R. 5034 by discriminating against out-of-state *products*. Today, under *Bacchus*, discrimination between in-state and out-of-state products is as much a Commerce Clause violation as discriminating between in-state and out-of-state businesses. But H.R. 5034 does not recognize discrimination based on products. For example, a state like New York where no zinfandel is produced could ban sale and shipment of zinfandel to New York residents. That would discriminate against California zinfandel producers without incurring scrutiny under H.R. 5034. H.R. 5034 therefore leaves states free to reformulate their alcohol regulations to discriminate against out-of-state entities without possibility of judicial scrutiny, so long as they do so surreptitiously, and without expressly discriminating against out-of-state wine.

"The Commerce Clause forbids discrimination, whether forthright or ingenious." *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994). At the core of the Supreme Court's Commerce Clause jurisprudence is what the Court called its "duty to determine whether the statute under attack, whatever its name may be, will in its practical operation work discrimination against interstate commerce." *Id.* (quoting *Best & Co. v. Maxwell*, 311 U.S. 454 (1940)). Fulfilling that duty requires a "sensitive, case-by-case analysis of [a statute's] purposes and effects." *Id.* H.R. 5034 nullifies this thoughtful specific framework and replaces it with the vague, intrusive standard of discriminatory intent. But again, courts hesitate to narrowly inquire into legislative intent, and H.R. 5034 would *prevent* courts from considering challenges based on discriminatory effects.

H.R. 5034 would thus overrule the First, Sixth, and Seventh Circuit decisions discussed above that struck down facially neutral statutes discriminating against out-of-state wineries. It would also arguably overrule half of *Granholm* itself, for the *Granholm* Court invalidated a New York statute that required an out-of-state winery to establish a physical presence in New York. The only discriminatory statutes that could still be challenged under H.R. 5034 would be ones like the Michigan statutes the *Granholm* Court struck down, which facially discriminated against out-of-state wineries explicitly. That, plainly, is only a narrow slice of the state discrimination that Congress should be concerned about, and that the Commerce Clause has so far guarded against.

4. Conclusion

H.R. 5034 is an invitation for undemocratic subterfuge by state legislatures, and it eviscerates the foundations of the Commerce Clause by dramatically limiting its application. Today, interstate wine shipping is available in 37 states and the District of Columbia. There is more, and clearer, regulation of wine than ever before. Simply put, H.R. 5034 is a drastic solution to a problem that does not exist. The wholesalers defend their monopolistic self-interest under the guise of a constitutional conflict between federal and state's rights guaranteed by the Twenty-First Amendment. H.R. 5034 in its original or amended form is a transparent attempt to maintain a lucrative anomaly for a few by eviscerating the Commerce Clause—the foundation of our economic union. This Committee should decisively reject H.R. 5034.