OBSTRUCTING COMMERCE: ONLINE SALES AND DIRECT SHIPMENT

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Several industries, including sellers of products as diverse as alcoholic beverages, cigarettes, automobiles and caskets, have for years used the legal system to create for themselves what they would call a protected niche but what others would call a monopoly. The legal arguments used to sustain these monopoly markets have become as aged as the wine they attempt to protect, but one-by-one the walls are tumbling down. In a continuing series of cases begun in February of 2000 consumers and out-of-state wine sellers challenged several state laws restricting the sale of alcoholic beverages. Despite a *spirited* defense of these laws by state attorney generals protecting their statutes and alcohol wholesalers protecting their monopoly, as well as decades of precedents favoring the industry, defense motions to dismiss the cases were denied and consumers prevailed, often by summary judgment. The middlemen wholesalers who are the beneficiaries of this legal protection scheme have been overwhelmed by the demand created by e-commerce, with its promise of lower prices.[2]

In general, wholesalers and states argue that various restrictions on the sale of alcohol are a constitutionally protected exercise of a state's sovereign regulatory power under the Twenty-first Amendment and point to the strict system of licensing set up after Prohibition to keep mobsters out of the liquor business. When the Twenty-first Amendment repealed Prohibition in 1933, most states adopted a three-tier system of manufacturers, wholesalers, and retailers. No owner could invest in more than one tier so the laws effectively prohibit manufacturers from owning a retail license, thus preventing them from selling over the Internet. Making direct purchases by consumers from out-of-state illegal may or may not deter mobsters, but it clearly serves to limit consumer choice and protect in-state wine wholesalers.[3] There are 2,000 wineries with 7,000 different wines in the U.S.; most are too small to produce enough wine to attract wholesalers, so they rely heavily on direct sales to consumers[4].

I. Dickerson

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[2] Wine and spirits have the most expensive distribution system of any packaged-goods industry by far, with margins more than twice those in the food business. *Vintage System: Big Liquor Wholesaler Finds Change Stalking its Very Private World*, Wall St. J., Oct. 4, 1999, at B1.

[3]The middleman's role is enormously lucrative, accounting for 18% to 25% of the cost to the retailer. Miami-based Southern Wine and Spirits alone reaps $2.3 billion in annual revenue - more than seven times the dollar volume of direct wine shipments to consumers nationwide. *Clint Bolick (Institute for Justice) Wine Wars: Lift the Ban on Out-of-State Sales?* Wall St. J., Feb. 7, 2000, at A1.

[4] San Ant. Express News, Aug 1, 2003, at 1C.

Dickerson v. Bailey[5] was brought by wine drinkers in Houston against the administrator of the Texas Alcoholic Beverage Commission (TABC), alleging that restrictions in the state's alcoholic beverage code which kept them from purchasing wines directly from out-of-state suppliers limited their participation in interstate commerce and violated the Commerce Clause of the U.S. Constitution[6]. Like most states, Texas has a three-level permit system that requires consumers to purchase only from licensed retailers, who may purchase only from licensed wholesalers, who must purchase only from licensed producers. The threshold question was the same as in any Commerce Clause challenge: does the challenged statute discriminate on its face against interstate commerce and in favor of local businesses, thereby rendering it *per se* invalid, or does it regulate commerce evenhandedly with only incidental effects on interstate commerce? If the statute does not discriminate on its face then a balancing test is applied to determine its constitutionality, and the court should uphold the statute unless the burden it places on interstate commerce is clearly excessive in relation to its benefits. The plaintiffs in *Dickerson* claimed the three-tier system of liquor licenses in Texas impeded the free flow of goods from one state to another and was therefore *per se* illegal under the "dormant" Commerce Clause of the Constitution.[7]

Texas and the wholesalers argued that the three-tier system regulates commerce evenhandedly, with only incidental effects on interstate commerce, and therefore any discrimination was demonstrably justified by a valid factor unrelated to economic protectionism.[8] The regulation was defensible, they argued, because the Twenty-first Amendment grants states broad powers to regulate the transportation and importation of alcohol for delivery and use within their borders[9]. If wineries used catalogs or the Internet to sell their products the state might lose out on taxation and wine might be sold to minors. Fears about large companies with monopolistic tendencies dominating all levels of the alcoholic beverage industry were trotted out. Why, Texas might lose total control over the import and distribution of alcoholic beverages within its borders! The proper taxes might not be collected; shippers might ship to dry areas of the state; sales of alcoholic beverages to minors might increase.

The State and the wholesalers clearly prefer the Supreme Court's original view that the Twenty-first Amendment in essence repealed the Commerce Clause where liquor regulation was concerned.[10] The plaintiffs, however, had clearly done their homework. An FTC report that concluded that the states which allow direct shipping have procedural safeguards against shipments to minors and report “few or no problems” with these shipments was introduced.[11] Other court decisions were cited that suggest that states

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[5] 87 F. Supp 2d 691 (S.D. Tex. 2000)

[6] In Bacchus Imports, Ltd. v. Dias, 468 U.S. at 263 (1984) the Supreme Court stated that "[t]his 'negative' aspect of the Commerce Clause prohibits economic protectionism--that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." This "negative aspect" of the Commerce Clause, which "prevent[s] economic Balkanization" among the states, is commonly known as the "dormant Commerce Clause" doctrine.

[7] 87 F.Supp.2d 691 (S.D. Tex. 2000).

[8] *Id* at 697.

[9] *Id* at 701.

[10] State Board of Equalization v. Young's Market Co., 299 U.S. 59 (1936).

[11] "Possible Anticompetitive Barriers to E-Commerce: Wine", Fed. Trade Comm. Rep., July 3, 2003 at 22.

could require purchases to be made by credit card, require a sizable minimum purchase, require age verification by the seller through faxed identification and delivery only to an adult identified in the identification document, require labeling of products on the outside of shipping wrappers, or require age verification of the recipient by the transporter in order to avoid problems.[12] It was pointed out that trade associations representing alcohol manufacturers have already agreed to submit to state licensing and tax collection requirements.

The District court easily determined that the Texas Alcohol Beverage Code violates the Commerce Clause by discriminating against interstate commerce, favoring in-state economic interests at the expense of out-of-state interests. But does the Twenty-first Amendment 'save' the statutes from invalidation?[13] Since the court had no trouble imagining reasonable, nondiscriminatory alternatives to the state's interests in taxes and dry areas, the court found that the Twenty-first Amendment, appropriately narrowed and modified, was no longer sufficient to save the regulations from invalidation under the Commerce Clause.[14] The state could impose an alternative collection of revenue on out-of-state wine sales and there are criminal laws that prohibit the sale of alcoholic beverages to a minor and prohibit carriers from transporting and delivering alcoholic beverages to a person in a dry area. The state could not prove that the local benefits justified the Commerce Clause violation and neutral alternatives were available to protect the state's interests, thus the total ban on direct shipments to consumers was over-inclusive.

Texas consumers were allowed to purchase wines directly from out-of-state sellers and ship wines purchased elsewhere to their homes in Texas. After rebuking the defendants for relying largely on older cases that fail to reflect the marked evolution of law in this area, Judge Harmon concluded "The Court finds that there is no temperance goal served by the statute since Texas residents can become as drunk on local wines or wines of large out-of-state suppliers able to pass into the state through its distribution system, and available in unrestricted quantities, as those that, because of their seller's size or (other) constraints, are in practical effect kept out of state by the statute."[15]

II. Dickerson

In *Dickerson I* Judge Harmon partly relied on a contemporaneous Indiana case that had granted summary judgment to some wineries while holding rather broadly that the Twenty-first Amendment does not immunize state liquor control laws from invalidation under the Commerce Clause.[16] The Indiana statute made it unlawful for persons in another state to ship alcoholic beverages directly to an Indiana residence and the chief question was whether this regulation was so closely related to the powers reserved by the Twenty-first Amendment that it should prevail even if its requirements directly conflict with the Commerce Clause. Shortly after *Dickerson I* was decided,

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[12] Brown & Williamson Tobacco Corp. v. Pataki, 2000 WL 1694307 (S.D.N.Y 2000)
[13] *Id* at 693.
[14] *Id* at 697.
[15] Dickerson v. Bailey, 212 F.Supp.2d 673, 710 (D.C. Tex. 2002).
[16] Bridenbaugh v. O'Bannon, 78 F. Supp. 2d 828 (N.D. Ind. 1999).

however, the Seventh Circuit reversed the Indiana case, viewing it as a direct challenge to the entire three- tier distribution system.[17] The Seventh Circuit thus allowed Indiana to control alcohol any way it likes, pursuant to the Twenty-first Amendment, so long as it treats the importation of liquor similarly to the way it treats in-state sales of liquor.

Upon the defendants' motion for reconsideration, both sides refreshed their arguments in light of the Seventh Circuit's opinion and prepared for *Dickerson II*. The state now argued for the first time that the prohibition against direct shipment of wine by out-of-state wineries to ultimate-consumer, in-state residents also applies to in-state wineries and since both in-state and out-of-state wineries are treated in the same way there is no discrimination. Before this argument could be considered, the Texas legislature rescued the plaintiffs by passing the Texas Wine Marketing Assistance Program Act.[18] The new statute expressly stated that its purpose was to "assist Texas wineries in capturing a greater part of the market for wine, at the expense of out-of-state wineries",[19] thus ratifying the original intent of the regulations - economic protectionism. The new statute allows Texas wineries to sell to in-state buyers over the Internet, but they must ship the wine to a package store rather than directly to a customer. There is an exception: Texans can have it shipped directly to their homes only if they visit a Texas winery and order it there. Out-of-state companies must go through a wholesaler and then a retailer to get their wine to Texas consumers. Banning direct shipments by out-of-state wineries also hurts Texas wineries because Texas wineries cannot sell directly to customers in states that require reciprocity agreements. Sellers must buy permits for $100 allowing them to ship directly to Texans for personal use. A Texas purchaser must be at least the legal drinking age of 21. No more than three gallons of wine may be shipped to the same buyer or address within a 30- day period and it cannot be shipped into "dry" areas which don't allow alcoholic beverage sales. The holder of a wine-shipper's permit must pay all taxes, including sales taxes, and the package must be labeled with a notice that it contains alcohol and signed for by someone who is at least 21.[20]

Once again Judge Harmon struck down the Texas regulatory scheme, examining the statute in the context of the dormant Commerce Clause and giving prominence to "economic determination resulting from a state's disparate application of its regulatory scheme to favor local producers over out-of-state producers."[21] For the second time she found the Texas scheme to be facially discriminatory in violation of the dormant Commerce Clause. She also found that the statutes were not "saved" by the Twenty-first Amendment. As for the Seventh Circuit's opinion that would give the states an absolute right to regulate liquor under the Twenty-first Amendment, she actually challenged the author of the Seventh Circuit's opinion for using terms like "orderly market conditions" ("a euphemism for reducing competition and facilitating tax collection") and "express grant of plenary power" ("this reveals his own leaning"). She even asserted that the Seventh Circuit's deference was based on a flawed interpretation of the Constitution.[22]

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[17] Bridenbaugh v. Freeman-Wilson, 227 F.3d 848 (7th Cir.2000).
[18] Tex. Alco. Bev. Code sec. 110-001-055 (West Supp. 2002).
[19] *Id*.
[20] *Id*.
[21] Dickerson v. Bailey, 212 F.Supp.2d 673, 679 (D.C. Tex. 2002).
[22] Reviewing the ratification debates, judge Harmon concludes that the plain meaning of the Twenty-first Amendment "is anything but plain with respect to the language used and the historical context, as

The greatest flaw in the Seventh Circuit's opinion was that "it did not even mention the burdens on small out-of-state wineries or consumers that might result from the regulatory process, thus ignoring the last forty years of Supreme Court cases balancing the dormant Commerce Clause and the Twenty-first Amendment".[23]

III. The Fifth Circuit Affirms

The Fifth Circuit showed little patience with the state's reformulated arguments in *Dickerson II* and went so far as to accuse the State of misrepresenting the central legal issue of the case.[24] Noting that only after the Seventh Circuit's decision did the TABC argue that the plaintiffs were attempting to overthrow the entire three-tier system and establish an unregulated, national market in wine, the court accepted the plaintiffs' express disavowal of this alleged purpose. The Seventh Circuit's finding that the Twenty-first Amendment authorizes the three-tier system was qualified by the inclusion of the phrase "unless the state has used its power to impose a discriminatory condition on importation."[25] The Fifth Circuit found that the Texas scheme clearly discriminated against out-of-state wineries and upheld an injunction against the enforcement of the TABC statutes. When the TABC decided not to appeal to the Supreme Court, it had to pay attorney fees to the plaintiffs of about $160,000 for the lower court case and the appeal.[26]

IV. Other States

By September of 2000, District courts in seven states[27] had concluded that alcoholic beverage statutes in their states were in violation of the dormant Commerce Clause. Some states upheld the statutes anyway, finding them a constitutional exercise of sovereign regulatory power under the Twenty-first Amendment even though they "may have protectionist overtones".[28] When there are mixed motives, some legitimate and some protectionist, the legitimate motives sometimes outweigh the burden placed on interstate commerce. Sometimes the statutes are "saved" by the Twenty-first

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evidenced by conflicting views of courts and legal scholars throughout the twentieth century." Dickerson v. Bailey, 336 F. 3d 388, 394 (5th Cir. 2003).

[23] *Id*. at 400.

[24] Id. at 404. "The Administrator's contentions here are nothing short of outright mischaracterization of both the statutes he is charged with enforcing and the legal position unambiguously espoused by Plaintiffs".

[25] Bridenbaugh v. O'Bannon, 78 F.Supp.2d 828 (N.D.Ind.1999).

[26] San Ant. Express News, Aug. 26, 2003 at 1F.

[27] New York (Swedenburg v. Kelly, 2000 WL 1264285, (S.D.N.Y.2000); Indiana (Bridenbaugh v. O'Bannon, 78 F.Supp.2d 828 (N.D.Ind.1999); Texas (Dickerson v. Bailey, 87 F.Supp.2d 691 (S.D.Tex.2000); Illinois (Kendall-Jackson Winery, Ltd. v. Branson, 2001 WL 199811, (N.D.Ill., 2001); Florida (Bainbridge v. Bush, 148 F.Supp.2d 1306, (M.D.Fla., 2001); Virginia (Bolick v. Roberts, 199 F.Supp.2d 397, (E.D.Va., 2002); N. Carolina (Beskind v. Easley, 197 F.Supp.2d 464, (W.D.N.C.,2002).

[28] Bainbridge v. Bush, 148 F.Supp.2d 1306, (M.D.Fla., 2001).

Amendment.[29] According to the *Wall Street Journal*, some states have made it easy to order wine online, some are still tricky, some remain tough, and there are seven states where bypassing wholesalers is sometimes a felony.[30] There are stories in the media of restaurateurs who have wine shipped in unmarked boxes, sellers who ask customers to provide an address in another state, and shipments of "Olive Oil" in brown packages going all over the country.[31]

In a national test case, filed in New York because it is the second-largest wine market after California, the Institute for Justice sued four large liquor wholesalers on behalf of small wineries and consumers, arguing that the state's direct shipment laws violated the Commerce Clause, the economic liberty of consumers under the Privileges and Immunities Clause and the free speech rights of consumers.[32] The Institute calls such laws "the oldest gambit of American politics: economic protectionism." Such laws are "designed to preserve the monopoly of liquor wholesalers who control all out-of-state wine…".[33] The lawsuit argued that the restrictions on interstate wine shipping make it impossible for out-of-state wineries to ship wine to New York consumers, trammeling their economic liberty.[34] The state relied on its alleged absolute power under the Twenty-first Amendment to regulate the distribution of alcohol. The Amendment, they claimed, insulates them from any constitutional attack. As to the privileges and immunities claim, the state said the wineries are not natural persons, and therefore, not protected by the Privileges and Immunities Clause[35]. In an opinion with national ramifications for Internet commerce, the court denied motions to dismiss and delivered a victory for wineries and consumers. It would allow "only those restrictions which directly promote temperance", treat the proprietors of wineries as "citizens" under the Privileges and Immunities Clause, and ignore defendant's claim that the advertising ban poses only a minimal restriction on commercial speech concerning an unlawful activity[36]. When the case was actually tried in 2002 the result was another summary judgment for the plaintiffs.[37]

The Second Circuit, however, saw it differently. On February 12, 2004 it joined the Seventh Circuit and rejected the analysis of its trail court and at least four other Circuits as "unnecessarily limiting the authority delegated to the states through the clear

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[29] Beskind v. Easley, 197 F.Supp2d 464 (W.D.N.C. 2002; Bolick v. Roberts, 199 F.Supp.2d 397 (E.D. Va. 2002).

[30] Clint Bolick (Institute for Justice) *Wine Wars: Lift the Ban on Out-of-State Sales?*, Wall St. J., Feb. 7, 2000 at A3. Wineries may ship to your house in California, Colorado, Hawaii, Idaho, Iowa, Minnesota, Missouri, New Mexico, Oregon, Washington, Wisconsin and West Virginia. Sellers may ship to your house only if they have a state permit in Alaska, Connecticut, Louisiana, Montana, Nebraska, Nevada, New Hampshire, North Dakota and Wyoming. Direct shipping is still illegal in Arizona, Alabama, Delaware, Kansas, Maine, Massachusetts, Michigan, Mississippi, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont and Virginia. It's a felony to ship wine and a conspiracy to commit a felony to receive out-of-state wine in Florida, Georgia, Kentucky, Maryland, Tennessee, Indiana and North Carolina.

[31] Quentin Hardy, *A Cabernet to Go, Please and Put it in a Brown Wrapper, Wall St. J.,* Sept. 3, 1997 at A1.

[32] Swedenburg v. Kelly, 32 F. Supp. 2d 135 (S.D.N.Y. 2002).

[33] Media advisory from the Institute for Justice, *Federal Court to hear Wine Case*", July 21, 2000.

[34] *Id.*

[35] Loretto Winery, Ltd. V. Duffy, 761 F2d 140 (2d Cir 1985).

[36]Swedenburg v. Kelly, 2000 WL 1264285, (S.D.N.Y.2000).

[37] Swedenburg v. Kelly, 32 F. Supp. 2d 135 (S.D.N.Y. 2002).

and unambiguous language of the Twenty-first Amendment".[38] After recounting the legal history of Prohibition, the court made it clear that it would not allow dormant Commerce Clause concerns to restrict state regulatory schemes that focus on the importation of liquor.[39] The court could find no indication that the regulatory scheme in New York is intended to favor local interests over out-of-state interests since all sellers must utilize the three-tier system or obtain a physical presence from which the state can monitor and control the flow of alcohol. All wineries are permitted to obtain a license as long as they establish a physical presence in the state. Wine that is delivered to a branch office or warehouse can then be shipped directly to consumers. This is exactly the kind of reasoning that has been called an "absurd oversimplification" by the Sixth Circuit. If the Twenty-first Amendment has somehow "repealed" the Commerce Clause wherever regulation of liquor is concerned then Congress would be left with no regulatory power over interstate commerce in liquor, a conclusion the Sixth Circuit has called "patently bizarre" and "demonstrably incorrect".[40]

V. The Role of the Supreme Court

Both sides have claimed support in Supreme Court decisions. The wineries argue that the Court's view of the state's power to regulate liquor importation under the Twenty-first Amendment in view of the Commerce Clause has increasingly been narrowed and modified during the past sixty years.[41] As more and more states enacted economic protection statutes and regulations, they argue, the Supreme Court has more carefully scrutinized the actual purpose behind the laws and has stricken as unconstitutional alcoholic beverage statutes with a direct impact on interstate commerce.[42] They cite *North Dakota v. United States* [43] for the proposition that regulation is proper only if it regulates in a non-discriminatory manner and is intended to advance the "core concerns" of the Twenty-first Amendment - namely temperance, the promotion of orderly market conditions, and revenue production. They quote from the *Bacchus Imports* case:

> "The central purpose of the Twenty-first Amendment was not to empower States to favor local liquor industries by erecting barriers to competition… State laws that constitute mere economic protectionism are therefore not entitled to the same deference as laws enacted to combat the perceived evils of unrestricted traffic in liquor."[44]

The wholesalers acknowledge that recent cases have limited the application of the Twenty-first Amendment to the regulation of alcohol and that the Supreme Court has viewed with caution attempts to invoke the Amendment as a pretext for economic

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[38] Swedenburg v. Kelly, 2004WL254401 (2004)
[39] *Id.*
[40] Heald v. Engler, 342 F.3d 517 (6th Cir., 2003)
[41] Dickerson v. Bailey, 336 F.3d 388 (5th Cir.2003).
[42] Bacchus Imports Ltd. v. Dias, 468 U.S. 275 (1984); Brown-Forma, 476 U.S. 573 (1986); Healy v. The Beer Institute, Inc., 491 U.S. 324 (1989).
[43] 495 U.S. 423 (1990).
[44] Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984).

protectionism.[45] While admitting that state statutes requiring business operations to be performed in the home state that could more effectively be performed elsewhere are *per se* illegal, they clearly believe the language from the Second and Seventh Circuit opinions declaring that business efficiency must give way to valid regulatory concerns in this "unique area of commerce"[46] and the *Swedenburg* warning that "changes in marketing techniques or national consumer demand for a product do not alter the meaning of a constitutional amendment."[47] The Supreme Court has never held nor implied that laws prescribing regulations for the importation and distribution of alcohol within a state's borders are problematic under the dormant Commerce Clause.[48] Until it does, most state regulations in this area will remain valid.

VI. Conclusion

Special interest groups are using lawsuits in New York and other states to challenge the trade barriers against wine. The litigation campaign is aimed at decreasing the number of states with direct shipment bans and many states, including Virginia, North Carolina and Texas have decided to permit direct shipping as a result.[49] The Wine Institute, an advocacy group representing more than 80 percent of U.S. wine production, is also fighting restrictions on direct-to-consumer sales that limit competition and place constraints on consumer choice.[50] The current beneficiaries of regulation will undoubtedly fight to maintain their advantage by arguing that direct-to-consumer sales will make it easier for children to order alcohol and harder for states to collect taxes,[51] but challenges to the legitimacy of the three-tier system will make the wholesalers' job in keeping their monopoly that much harder.

The future of e-commerce will be jeopardized if all 50 states can set their own rules for what can be sold over the Internet or if they can ban out-of-state sales to protect state tax revenues or local merchants. The quest to establish an unregulated national market in wine will increase opportunities for small out-of-state wineries to access major markets, increase the variety of wines available to the consumer, and lower prices for everyone. States that erect statutory barriers to shield their merchants from the rigors of competition are finding that this is exactly the type of geographic discrimination that is prohibited by the Commerce Clause. The demand for Internet wine sales is a demonstration of the way that globalization, specifically globalization via the Internet, can erode trade barriers.[52]

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[45] *Id.*
[46] Swedenburg v. Kelly, 2004 WL 254401 (S.D.N.Y. 2004).
[47] *Id.*
[48] Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, (7th Cir.2000).
[49] Newsletter from the Institute for Justice, December 2003.
[50] *"E-Commerce: The Case of Online Wine Sales and Direct Shipment,* Statement of the Wine Institute to Congress, *Oct. 29, 2003.*
[51] Direct shipping states with delivery safeguards have "few or no problems" with underage access. Fed. Trade Comm., *Possible Anticompetitive Barriers to E-Commerce: Wine*, July, 2003.
[52] Many of the cases mentioned in this article have been granted certiorari by the Supreme Court. The consolidated cases of Granholm v. Heald, MI Beer & Wine Wholesalers v. Heald, and Swedenburg v. Kelly are set for oral argument on December 7, 2004.