No. 10-671

In The
Supreme Court of the United States

WINE COUNTRY GIFT BASKETS.COM, ET AL.,
Petitioners,

v.

JOHN T. STEEN, JR., ET AL.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR ECONOMISTS, LAW AND ECONOMICS SCHOLARS, AND FORMER FTC OFFICIALS AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

The amici curiae submitting this brief are economists, law and economics scholars, and former FTC officials who teach, conduct research, and publish on economics and economic regulation. A list of amici is set forth in the appendix hereto.

Amici have no financial interest in any party to the case or in the outcome of the case.

STATEMENT

Petitioners seek a writ of certiorari to review a decision of the United States Court of Appeals for the Fifth Circuit rejecting a challenge to a facially discriminatory Texas state law that permits in-state retailers to accept remote orders and directly ship alcoholic beverages but denies that same right to out-of-state businesses. Petitioners contend that the Texas law violates the dormant Commerce Clause of the United States Constitution as interpreted in *Granholm v. Heald*, 544 U.S. 460 (2005). The Fifth Circuit affirmed a grant of summary judgment in favor of Respondents, holding that Texas's discriminatory regime was permissible without requiring the state to justify its discrimination with a legitimate regulatory interest.

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[1] This brief is filed pursuant to notice provided to the parties more than ten days before the filing of the brief and their written consent. No counsel for a party authored this brief in whole or in part. Professors Todd Zywicki and Joshua Wright received funding for preparation and submission of this brief from Family Winemakers of California, a 625 member statewide association of wine producers, independently owned vineyards, and suppliers, founded in 1991 and based in Sacramento, California.

Amici fully endorse Petitioners' arguments explaining why a grant of certiorari is appropriate here. Amici write separately to highlight the harm to small wineries, consumers, and interstate commerce from allowing states to enact discriminatory barriers to interstate commerce in wine and other alcoholic beverages. The Federal Trade Commission describes discriminatory state laws inhibiting direct shipment as "the single largest regulatory barrier to expanded e-commerce in wine." FEDERAL TRADE COMMISSION, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE (2003) [hereinafter "FTC Report"], at 3, *available at* http://www.ftc.gov/os/2003/07/winereport2.pdf, and the decision below perpetuates this harm. Moreover, the Fifth Circuit's opinion will result in substantial harm to consumers, small wineries, and interstate commerce, and will invite evasion of *Granholm*'s protections by politicians and special interests seeking to erect protectionist policies, notwithstanding *Granholm*'s guarantee of equal access to America's markets for wineries and consumers. Given the importance of this issue to American consumers, small wineries, and interstate commerce, and the increasing uncertainty caused by tensions arising from judicial efforts to apply *Granholm* to various state laws, it is essential for this Court to review the decision of the Fifth Circuit. *See, e.g.*, *Freeman v. Corzine*, __ F.3d ___, 2010 WL 5129219 (3d. Cir. 2010) (applying *Granholm* to New Jersey law).

SUMMARY OF ARGUMENT

1. The decision below conflicts with this Court's reasoning in *Granholm v. Heald*, 544 U.S. 460 (2005),

undermines the system of nondiscriminatory and robust interstate commerce guaranteed by the Commerce Clause of the Constitution, and imposes unjustified injury on the nation's citizen-consumers and wine producers. The Texas regulatory scheme expressly discriminates between in-state and out-of-state wine retailers, striking at the heart of reasonable, non-discriminatory regulation recognized in *Granholm*.

2. The decision below will result in substantial harm to consumers, small wineries, and interstate commerce. It rests on three fundamental errors with profound economic consequences. First, the Fifth Circuit improperly limits *Granholm* and thus the dormant Commerce Clause's protections to "producers." As such, a retailer of wine is protected by *Granholm* only if it is also vertically integrated into production of the wine that it sells even if distribution through a retailer would be more efficient. Neither *Granholm*'s logic nor the dormant Commerce Clause compel the vertical integration of production and retailing to gain the protection of the dormant Commerce Clause.

Second, rather than applying the two-step analysis mandated by *Granholm*, the Fifth Circuit began and ended its analysis with the dicta in *Granholm* that the three-tier system is "unquestionably legitimate." 544 U.S. at 489 (quoting *North Dakota v. United States*, 495 U.S. 423, 432 (1990)). The Fifth Circuit, finding that discrimination is inherent in the three-tier system, read this passage as endorsing discrimination against out-of-state retailers.

Third, the Fifth Circuit's opinion fails to properly consider the constitutional and economic purposes of the dormant Commerce Clause and the need to limit evasion of this Court's *Granholm* decision by states and interest groups seeking to erect discriminatory barriers to interstate commerce. These three misapplications of *Granholm* and the dormant Commerce Clause underscore the need for this Court to reaffirm *Granholm* in order to guarantee the benefits of the dormant Commerce Clause and to prevent further efforts to erect discriminatory barriers to interstate commerce.

3. *Granholm* expressly recognized the economic value of vigilant enforcement of the dormant Commerce Clause against discriminatory trade barriers. *Granholm* has mitigated but has not eliminated the central economic problem identified there: wholesaler consolidation and barriers to entry creating a bottleneck hampering the distribution of wine, especially the ever-growing number of small wineries seeking to bring their products to market. Permitting out-of-state retailers to compete on equal terms with in-state retailers will allow a more efficient system of distribution, reduce prices and increase variety for consumers, and enhance competitive opportunities for America's small wineries.

ARGUMENT

I. The Decision Below Undermines the Dormant Commerce Clause By Improperly Limiting *Granholm* to "Producers" and Consumers Who Buy Directly from Producers

The decision below rests on the flawed premise that *Granholm* applies only to "producers" and not to any other elements of the three-tier system. *See Wine Country Gift Baskets*, 612 F.3d at 818 ("The discrimination that *Granholm* invalidated was a State's allowing its wineries to ship directly to consumers but prohibiting out-of-state wineries from doing so . . . . Such discrimination—among producers—is not the question today."); *id.* at 820 ("*Granholm* prohibited discrimination against out-of-state *products* or *producers*. Texas has not tripped over that bar by allowing in-state *retailer* deliveries.") This reading would foreclose more efficient systems of alcohol distribution, resulting in harm to consumers, small wineries, and interstate commerce.

Even a cursory reading of *Granholm* reveals that it focuses on "producers" simply because the plaintiffs in that case happened to be out-of-state producers and the state law in question was designed to benefit local producers. But its language and logic are not limited to producers. And for good reason. The dormant Commerce Clause protects not producers, but *commerce*—buying and selling—across state lines. Whether a retailer is also vertically integrated to production is immaterial to this protection.

Simply put, there is no basis in logic, economic reasoning, or constitutional law to justify an artificially narrow reading of *Granholm* that protects only "producers." By focusing on the identity of the seller of a product, the decision below ignores the fundamental principle of the dormant Commerce Clause—to promote consumer welfare and supplier competition in a national market unencumbered by discriminatory trade barriers. *See Granholm*, 544 U.S. at 473 ("Laws of the type at issue in the instant cases contradict the[] principles [of the dormant Commerce Clause]. They deprive citizens of their right to have access to the markets of other States on equal terms.")

Furthermore, *Granholm* did not merely establish Commerce Clause protections for wine producers, but also for *consumers and sellers* to transact free of discriminatory state regulation. As the Court explained at the outset of its opinion, "States may not enact laws that burden out-of-state producers *or shippers* simply to give a competitive advantage to in-state businesses." *Id.* at 472 (emphasis added). This Court only mentioned the plaintiffs' status as "producers" because the particular Michigan and New York laws in question exempted in-state producers from sales restrictions those same laws imposed upon out-of-state wine producers. That the out-of-state sellers in that case also happened to produce the products that they sold was coincidental to *Granholm*'s conclusion. The relevant question instead is rather whether similarly-situated sellers of a product were being treated

in a non-discriminatory manner.[2] Nothing in *Granholm* or any other case supports the Fifth Circuit's contention that only production *combined with* retail sale is protected by the dormant Commerce Clause.

Under the Fifth Circuit's logic, a producer would lose the dormant Commerce Clause's protection if it decided that it would be more efficient to sell to consumers via a retailer instead of directly distributing its own products. Distribution through a professional retailer provides multiple economic benefits which redound to consumers. Retailers develop expertise in marketing and selling wine to consumers that individual wineries may lack, especially smaller wineries. Retailers have economies of scale in marketing, order fulfillment, and tax and regulatory compliance that allow them to sell to consumers at lower expense and with greater efficiency than small wineries. Specialty retailers may also be a credible source of product information to consumers. These benefits provide consumers with greater choice, reduced prices, and reduced information costs in choosing and purchasing wine products. All of these benefits of the ability to use professional retailers to market products are of particular benefit to smaller wineries and, in turn, to wine consumers.

Under the Fifth Circuit's flawed theory, however, the dormant Commerce Clause protects only consumers seeking to buy products *produced by the seller* from whom the consumer wishes to purchase. This

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[2] *See Freeman*, __ F.3d at *8 (holding that out of state producers that sell wine "at retail to consumers" must be treated on equal footing as in-state producers that sell wine "at retail to consumers").

would imply, for example, that *Granholm* protects a consumer sending a gift basket of wine or enrolling in a "wine of the month" club—but only if the order itself is to be fulfilled by one winery filling its own order. This proposed constitutional limitation begs questions. Would two small wineries that banded together to offer gift baskets that combine their wines into one basket be protected from state-sanctioned discrimination? Would three wineries within a marketing cooperative to jointly market and fulfill orders for their products be protected? Presumably under the Fifth Circuit's opinion, all commercial arrangements other than a single retailer vertically integrated from production of wine to retail sale would fall outside *Granholm* because each individual winery was not receiving and fulfilling each individual order, even if a third party could do so at lower cost and higher consumer value.

Nothing in *Granholm* compels this absurd result. The dormant Commerce Clause does not require vertical integration for its protections. Indeed, this Court has emphasized that "the imposition of a differential burden on any part of the stream of commerce—from wholesaler to retailer to consumer—is invalid, because a burden placed at any point will result in a disadvantage to the out-of-state producer." *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 202 (1994). There is nothing in the dormant Commerce Clause that conditions non-discriminatory access to markets on adopting a specific mode of business organization or method of distribution.

II. The Decision Below Improperly Dispenses With *Granholm*'s Two-Step Dormant Commerce Clause Analysis

The Fifth Circuit erred in reading *Granholm* as endorsing all three-tier systems as "unquestionably legitimate," even those that discriminate against out-of-state shippers. Under *Granholm*, however, the Court is required to apply a two-step process of analysis that is designed to protect interstate commerce by ensuring that discriminatory barriers to interstate commerce in alcohol are justified. This analysis begins with a determination of whether the discrimination was necessary to effectuate the state's regulatory scheme. Only afterwards may the court consider whether the Twenty-First Amendment saved the discriminatory regulation.

This analysis is the same whether the product in question is fresh grapes or grapes that have been vinted into wine. *See, e.g.*, *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994). When a state enacts a discriminatory regulatory regime governing alcohol, the state must justify the discrimination as necessary to the fulfillment of legitimate regulatory purposes. Texas's regulatory regime discriminates against out-of-state wineries and merchants.

Yet, the Fifth Circuit began and ended its analysis with *Granholm*'s dicta dubbing the three-tier system "unquestionably legitimate," *Granholm*, 544 U.S. at 489, in the abstract. The court did not consider the discriminatory nature of the state regulation much less whether it was justified. Because it was part of a three-tier system, the court found it insulated from the application of the dormant Commerce Clause.

Notably, the Fifth Circuit erroneously concluded that discrimination at the retail level is integral to the three-tier system. The Fifth Circuit thereby characterized this case as a frontal challenge on the validity of the entire three-tier system itself. But discrimination is not inherent to the operation of the three-tier system. As Petitioner notes, several states operate three-tier systems without discrimination. *See* Brief for Petitioner at 13. There is nothing inherent in the three-tier system that would justify allowing in-state retailers but not out-of-state retailers to accept remote orders and fulfill them by delivery.

As the Court recognized in *Granholm*, the purpose of Section 2 of the Twenty-First Amendment was the same as the purpose of the Wilson and Webb-Kenyon Acts that preceded it: to allow the state police power to regulate alcohol moving in interstate commerce to the same extent as alcohol in intrastate commerce but subject to the limitation that states could not erect discriminatory barriers. *Granholm*, 544 U.S. at 484-85. The Twenty-First Amendment, like its predecessors the Wilson and Webb-Kenyon Acts, intended to grant the states regulatory *parity* – to prevent states from having to treat out-of-state retailers of alcohol on *more favorable* terms than in-state vendors, not to permit plenary authority to discriminate against interstate commerce. Todd Zywicki & Asheesh Agarwal, *Wine, Commerce, and the Constitution*, 1 N.Y.U. J. LAW & LIBERTY 609 (2005).

The three-tier system may be, as a starting point, "unquestionably legitimate." But this does not authorize states to violate the Commerce Clause any more than it would authorize a state to violate any

other Constitutional protection as part of the implementation of the three-tier system. *See* Zywicki & Agarwal, *supra*, at 639-40. While some early cases suggested that the Twenty-First Amendment essentially repealed the dormant Commerce Clause as it applied to interstate commerce in alcohol, those same cases asserted that the Twenty-First Amendment also protected state alcohol regulation from scrutiny under the Fourteenth Amendment. *See Bd. of Equalization of Cal. v. Young's Mkt. Co.*, 299 U.S. 59, 64 (1936) (rejecting Equal Protection challenge to state alcohol regulation as "[a] classification recognized by the Twenty-First Amendment cannot be deemed forbidden by the Fourteenth.") As this Court has subsequently and repeatedly recognized, the Twenty-First Amendment no more deprives citizens of the dormant Commerce Clause's protection from discrimination than it protects them from discrimination under the Fourteenth Amendment. *See Craig v. Boren*, 429 U.S. 190 (1976) (holding that "the operation of the Twenty-first Amendment does not alter the application of the equal protection standards that would otherwise govern this case").

The decision below thus rests upon fundamental doctrinal and conceptual errors that sharply undermine the dormant Commerce Clause. Review is warranted so that this Court preserve the protections of the dormant Commerce Clause for consumers and wineries and prevent evasion of *Granholm* by interest groups and state legislatures.

III. The Failure of the Fifth Circuit To Properly Apply *Granholm*'s Two-Step Analysis Will Encourage Protectionist Regulation, Harm Consumers, and Harm Interstate Commerce in Violation of the Constitution

The Fifth Circuit's failure to properly conduct *Granholm*'s two-step analysis injures consumers and the economy by undermining the integrated national economy the dormant Commerce Clause protects. Application of the two-step analysis required by *Granholm* is necessary in order to prevent evasion of the dormant Commerce Clause's anti-discrimination mandate thereby ensuring that laws further regulatory, not protectionist, purposes. Insulating the whole three-tier system from judicial review invites circumvention of this Court's *Granholm* decision through legislative gerrymandering. The only relevant question left for states would be how to plausibly label all manners of discriminatory interstate protectionism as essential to the three-tier system.

This threat is especially dangerous in the area of alcohol regulation, where as Nobel Laureate Daniel McFadden has observed, the political economy of state legislative and regulatory process systematically disadvantage the interests of consumers and out-of-state suppliers relative to those of wholesalers. *See* Daniel L. McFadden, E. Morris Cox Professor of Econ., Univ. of Cal., Berkeley, Interstate Wine Shipments and E-Commerce 2, *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/mcfadden.pdf ("I find it particularly sad that the anti-interstate shipping legislation that has been passed is so disproportionate in its negative impact on consumers relative to the very modest protection it provides to traditional distributors and retailers.").

Absent rigorous scrutiny by federal courts, wholesaler-dominance of the legislative and regulatory processes will result in rampant evasion of the Court's holding in *Granholm* and significant welfare losses imposed upon consumers.

A. *By Refusing to Rigorously Scrutinize Discriminatory Regulation, the Fifth Circuit's Opinion Encourages Special Interests and State Politicians to Evade Granholm's Mandates.*

Interest groups and state legislatures have worked ceaselessly to undermine *Granholm*. Legislatures have developed several types of camouflage to salvage discriminatory regimes. The Fifth Circuit's opinion will greatly simplify this process: every discriminatory element that a state asserts as essential to its three-tier regulatory regime would be deemed "unquestionably legitimate." Indeed, the Fifth Circuit's interpretation renders *Granholm* itself a near-nullity, enabling direct shipments of wine directly from producers to consumers, but providing no other limits on regulations of a myriad of economically similar transactions (as noted above). It is essential for this Court to reaffirm the importance of *Granholm* to limit these evasions.

In 2007, two officials of the Federal Trade Commission undertook a comprehensive review of state legislative responses in the wake of *Granholm* and the negative impact those evasions continued to have on consumers and interstate commerce. Maureen K. Ohlhausen & Gregory P. Luib, *Moving Sideways: Post-*Granholm *Developments in Wine Direct Shipping and Their Implications for Competition*, 75 AN-

TITRUST L.J. 505 (2008). As Ohlhausen and Luib note, in the wake of *Granholm*, several states invented new restrictions on direct shipping that typically fall more heavily on out-of-state producers. These included restrictions such as on-site purchase requirements and production limitations.[3] In some cases, these new restrictions "effectively make direct shipping by out-of-state wineries economically impossible." Ohlhausen & Luib, *supra* at 506. They note that "[r]estrictions on direct shipping, including those enacted in the wake of *Granholm*, have adverse effects on consumers of wine. Such restrictions prevent consumers from conveniently purchasing many popular wines and from reaping significant price savings on some wines. Further, direct shipping fosters competition between online and offline sellers of wine—even if consumers choose to buy wine from bricks-and-mortar retailers." *Id.* at 506. They conclude that "[a] Commerce Clause challenge may be the only practical way to attack these restrictions and protect the interests of producers and consumers in enjoying the benefits of a competitive, national market." *Id.* Moreover, they warn that the failure of this Court to protect consumers and interstate commerce

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[3] *Family Winemakers of Cal. v. Jenkins*, 592 F.3d 1 (1st Cir. 2010) illustrates the importance of judicial vigilance to prevent evasion of the dormant Commerce Clause. In 2006 Massachusetts enacted a facially neutral law that created distinct distribution regimes for "small" and "large" wineries, as defined by output of more or less than 30,000 gallons per year. While facially neutral, the First Circuit recognized that no Massachusetts winery produced more than 30,000 gallons per year. The First Circuit thereby invalidated the state law under *Granholm* as discriminatory in effect.

from these evasions will invite further surreptitious trade barriers erected to protect in-state merchants from out-of-state competition.

As this legislative response to *Granholm* indicates, state legislatures are highly prone to erecting harmful discriminatory barriers to interstate commerce. Consumer interests tend to be systematically underrepresented in political processes as consumers are subject to collective action and free-riding problems. *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1965). By contrast, wholesalers present a cohesive, well-organized lobbying machine. Such an asymmetry in lobbying power increases the threat of protectionist legislation motivated by wholesaler special interest groups. Thus, allowing states to authorize alcohol cartels enables financially interested firms to reap cartel profits at the expense of consumers, often in ways that do not materially further any legitimate interest of the state.

Studies of state alcohol markets confirm these suspicions. In most states, wholesalers and state governments combine to impose losses on consumers to increase both profits and tax revenues. *See* James C. Cooper & Joshua D. Wright, *State Regulation of Alcohol Distribution: The Effects of Post and Hold Laws on Consumption and Social Harms* (Fed. Trade Comm'n, Working Paper No. 304, August 2010) (demonstrating that state post and hold regulations result in a reduction in consumer welfare with no offsetting reduction in the social harms associated with alcohol consumption), *available at* http://www.ftc.gov/be/workpapers/wp304.pdf; Gina M. Riekhof & Michael E. Sykuta, *Politics, Economics,*

and the Regulation of Direct Interstate Shipping in the Wine Industry, 87 AM. J. AGRICULTURAL ECON. 439 (2005); Gina M. Riekhof & Michael E. Sykuta, *Regulating Wine by Mail*, 27 No. 3, REG. 30 (2004). Riekhof and Sykuta conduct an empirical analysis of state wine direct shipping "reciprocity" laws to find that interest-group struggles and tax revenues primarily determine state alcohol regulatory policies. In a few states, the domestic wine industry is sufficiently strong and well-organized that it can sometimes exert a counter-weight to anti-consumer wholesaler interests. Riekhof and Sykuta find that consumer interests predominate in absolutely no states. When a state lacks a large wine-producing sector that can provide a political counterweight to wholesaler interests, however, consumers are at the mercy of wholesaler interests.

By limiting the capacity of states to engage in discriminatory regulation, a primary function of the dormant Commerce Clause is to temper the ability of local interest group factions to weaken national markets and erode individual liberty. THE FEDERALIST No. 10 (James Madison). Discriminatory laws transfer wealth to small, cohesive special interests at the expense of millions of consumers that are hard to organize politically and out-of-state sellers that have no ability to vote and limited ability to participate in state political processes. These trends reflect the grim reality that discriminatory interstate laws tempt politicians to reward special interest groups at the cost of consumer welfare. These forces underscore the need for vigilance by this Court to prevent interest-group motivated evasions of the dormant

Commerce Clause. *See* Cass Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689 (1984).

B. By Failing to Rigorously Scrutinize Protectionist State Regulation, the Fifth Circuit's Opinion will Result in Substantial Harm to Consumers, Out-of-State Sellers, and Interstate Commerce.

This Court's decision in *Granholm* produced major economic benefits for consumers and the economy and led to a blossoming of smaller wineries by freeing new producers from an innavigable and shrinking bottleneck of wholesalers. As noted in *Granholm*, between 1984 and 2002 the number of licensed wholesalers nationwide dropped from 1,600 to 600 while the number of wineries had grown to over 3,000. *Granholm*, 544 U.S. at 467. Since *Granholm*, the number of wineries has increased to over 6,000, *see Growth of the U.S. Wine Industry*, http://www.wineamerica.org/newsroom/wine%20data%20center/2010-Growth-of-US-Wine-Industry.pdf (last visited Dec. 19, 2010), suggesting that discriminatory state regulation was a significant and binding constraint on competition and consumer choice in the wine market. By contrast, some industry analysts claim that the wholesaler industry has become even more consolidated and concentrated since then. Peter Zwiebach, *Consolidation Marches on as Leading Players Expand*, IMPACT: GLOBAL NEWS AND RESEARCH FOR THE DRINKS EXECUTIVE, Apr. 15-May 1 2009, at 1, 22. One indication of the wholesaler's regulatorily-preferred position is that while the return on equity (an accounting measure of profitability

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