

Coalition For Free Trade Position Paper

Possible Anti-competitive Efforts to Restrict Competition on the Internet"

**Prepared by Tracy Genesen
Legal Director , Coalition for Free Trade**

**Hyde , Miller, Owen and Trost
428 J Street.
Sacramento, California
95814
Phone: (916) 447-7933**

The Coalition for Free Trade (CFT) is a non-profit foundation of winery owners and legal experts. CFT was created to provide strategy and coordination for consumer based legal initiatives aimed at challenging direct shipping bans. On behalf of CFT, I submit this position paper as both an advocacy piece and a resource for the FTC to utilize as it examines anti-competitive efforts to restrict competition on the internet.

THE DEVELOPMENT OF A LEGAL STRATEGY FOR ERADICATING DIRECT SHIPPING BARRIERS.

The emergence of litigation as a means of eradicating statutory barriers to direct shipping of wine is the result of several converging factors. First, the organizing of frustrated consumers, collectors and wine critics intent on exercising their freedom of choice within the context of the legal system. Second, the severe restriction of wine manufacturers' efforts to market their products caused by the conjunction of a marked increase in wineries and a substantial reduction in the number of wholesalers. Third, the successful lobbying efforts by well-funded local wholesaler interests preventing the enactment of any direct shipping legislation in 26 states. And fourth, the rise of the convenience and freedom of internet e-commerce which allowed wine enthusiasts to locate sources of rare and desirable vintages.

While there are 26 states that currently have statutory direct shipping bans, just seven of these states were initially targeted to become the objects

of litigation. Those states are Indiana , Florida, New York, Texas, North Carolina , Virginia and Michigan. The statutes in these states were chosen for legal challenge for two reasons. First, these seven completely prohibit out-of-state wine producers from shipping their product to in-state consumers, *unless they possess a wholesale license or distribute their product using an in-state wholesaler*. Second, these statutory schemes explicitly allow for in-state wine producers to ship their products directly to consumers. These facially discriminatory statutes, which obviously favor in-state manufacturers and wholesalers over out-of-state manufacturers, form the most legally compelling basis for a constitutional challenge in the courts.

Ultimately, our goal is for a U.S. Supreme ruling that direct shipping bans of this kind are unconstitutional barriers to interstate commerce. We hope to see a ruling which recognizes that states can achieve their core concerns of temperance, taxation and providing for orderly market conditions through permit or reciprocity laws. The Supreme Court will most likely accept a direct shipment case for review where there is a split of decisions at the U.S. Court of Appeals level. Ultimately, if we win at the Supreme Court, CFT will then become one of the resources working with the Wine Institute and American Vintners Association on lobbying efforts designed to conform state law to Supreme Court precedent.

GLOBAL LEGAL ISSUES

The question of the constitutionality of state bans on the inter-state direct shipment of wine, has become increasingly controversial. The Supreme Court has not specifically spoken on direct importation of wine. Two Federal Appellate Courts have now spoken on this issue, the 7th Circuit in the Bridenbaugh v. Freeman-Wilson 227 F. 3d 848 (7th Cir. 2000) decision and most recently the 11th Circuit Court of Appeals in the Bainbridge et al v. Turner et al (D.C. Docket No. 99-02681-CV-T-27).

The Court in Bridenbaugh adopted the view that Section 2 of the 21st Amendment provides nearly plenary power to states to establish draconian regulatory systems as long as they claim that they are doing so to promote temperance, raise revenue and ensure orderly market conditions. The Bridenbaugh decision is representative of those opinions which view any inequitable results to consumers or wineries as being incidental or inconsequential.

The second group of opinions illustrated by the Bainbridge opinion reflects the most recent Supreme Court developments in dormant commerce clause analysis. In these opinions, the Courts give preeminence to economic discrimination resulting from a state's disparate application of its regulatory scheme to protect local producers from out of state competition.

This latter interpretation adopted in Bainbridge, recognizes the modern day distribution impediments facing small wineries and resulting constriction of consumer choice. These decisions seek to harmonize the relationship between Section 2 of the 21st Amendment and the Commerce Clause, to serve the Federal interests in free competition as well as the states interest to protect the health and welfare of its citizens, raise revenue, and maintain orderly market conditions. This more comprehensive, recent interpretation highlights the limitations on states' powers under the 21st Amendment, imposed by the dormant Commerce Clause. The Bainbridge analysis is as follows: If the court finds that the statute facially discriminates against out of state wine producers, it violates the commerce clause. The statute will then be invalidated, unless the statute advances a legitimate local purpose that cannot adequately be served by nondiscriminatory alternatives. If the state can demonstrate that there is no non-discriminatory means to achieve its core interests, then the statutes is saved from being invalidated by the dormant Commerce Clause.

The decisive issue framed by the Bainbridge court is whether the state can advance its core interests within the context of a regulatory statute which does not discriminate against out of state wine producers and constrict consumer choice. The position advanced by the state of Florida provides a representative sample of the type of argument asserting that a state must discriminate against out of state producers in order to achieve its core interests. The state of Florida has generally defended its discriminatory law as serving three interests: raising revenue, protecting minors and maintaining an orderly market place. Florida does not have to ban direct shipments in order to raise revenue. Like many other states, it can permit out of state wineries to obtain a license or permit to ship wine directly to consumers. The license or permit could cover the cost of regulation and be subject to revocation if appropriate taxes are not paid.

Florida makes the specious argument that direct shipment of wine into the state will lead to a substantial rise in underage drinking. First, juveniles who want to purchase alcoholic beverages do not order premium wines over the

internet. Second, Florida could require that out of state wineries appropriately label their products so that common carriers can require proof of age before delivering wine to consumers. Finally, according to the 2002 Pacific Research Study, states that allow internet sales of wine such as New Hampshire and Nebraska do not show an increase in under age drinking. The study goes on to say that New York State, which banned internet sales in 1997, attempted a sting operation in which minors would make illegal transactions over the internet. But before the operation began, the state attorney general office could not cite a single instance of minors acting on their own to buy alcohol using the internet. In addition, states with permit and reciprocity laws report no significant incidences of illegal internet sales to minors.

Lastly, the state of Florida argues that they would be unable to set up an efficient and orderly administrative system. The state of Florida can adopt an efficient administrative system to govern out of stateshipment of wine. The 13 states that have adopted reciprocity statutes and the 11 states which have enacted some form permit law devised such systems and do not report any administrative breakdowns.

Indeed, 11th Circuit Court of Appeals found that the state's proffered core concerns of protecting minors and ensuring orderly markets to be inadequate. The Court of Appeals vacated the judgment of the district court and remanded it for further consideration of the issue of whether the state can demonstrate "as a matter of law that its regulatory scheme is so closely related to the core concern of raising revenue as to escape Commerce Clause scrutiny." As indicated above, the state will have great difficulty in establishing that they cannot tax out of state wineries unless they discriminate against them.

WHOLESALE CONSOLIDATION AND WINERY EXPANSION

The majority of these prohibitive state statutes require that an out-of-state producer either possess a wholesale license or distribute their product through an in-state wholesaler. The substantial reduction in the number of wholesalers when combined with restrictive state statutes has strangled many wineries' ability to compete and grow under current market conditions. The Wine Spectator has recently authored a comprehensive article on direct shipping which analyzes the issues and challenges facing the wine industry. The October 15, 2002 issue of the Wine Spectator states,

"...[t]here were 2,188 wineries in the United States as of 2000, up from 579 in 1975, reports the Bureau of Alcohol, Tobacco and Firearms. The vast majority of those wineries produce less than 25,000 cases per year. In contrast, WSWA has 450 members in 1975, down to only 170 today." The distribution system for the wine industry has become hour-glass shaped: a large number of producers form the top, a vast number of consumers form the bottom, and in between are a small number of distributors that constrict the path through which wine products must flow to reach consumers." The constricting effect is magnified by the fact that wholesalers tend to focus almost exclusively on well-known, high-volume wine manufacturers to the exclusion of the smaller, less known brands. The combined effect of direct shipping prohibitions and wholesaler access obstacles is that small and medium-sized wineries are effectively precluded from developing or maintaining an out-of-state customer base.

STATUS OF DIRECT SHIPPING LAWSUITS

Currently, there are 6 active lawsuits awaiting decision at either the District Court or U.S. Court of Appeals level. The 7th, the Bridenbaugh case, filed by consumers and wine critics in 1998, challenging Indiana's felony statute, was decided in favor of consumers at the lower court level, but was subsequently reversed by the 7th Circuit Court of Appeals. In 2001, the Supreme Court declined to hear the case. In this case winery plaintiffs were conspicuously absent due to the industry's well-founded fear that participating in the litigation would result in retribution from their distributor. In the Bainbridge case, the 11th Circuit vacated the District Court's ruling finding that the state had not demonstrated, as a matter of law, that the Florida statutory scheme was necessary to achieve the state's core concerns of preventing underage drinking and ensuring orderly market conditions. The Court remanded the case back down to the District Court for further consideration of whether non-discriminatory alternatives are available to serve the state's interest in tax collection.

In recent months, consumers and wineries have secured victories at the Federal District Court level in Virginia, North Carolina and Texas and most recently New York. With the exception of New York, the states have filed appeals in these cases. In Texas, the 5th Circuit has set a briefing schedule in early January 2003. In Virginia and North Carolina,

all briefs have been submitted to the 4th Circuit. Oral argument has been set for the week of January 21st, 2003. The New York case is set for hearing on December 10, 2002 for the purpose of determining a remedy.

In the Michigan case, the District Court judge found that the state's statute violated the Commerce Clause, but was saved by the mere fact that the state indicated that their core concerns were advanced by the discriminatory statute. In our view, the Federal District Court in Michigan did not conduct the appropriate analysis, which would have required the states to demonstrate that their core concerns could not have been addressed through non-discriminatory means. We have also filed an appeal in the Michigan case, but it has not yet been scheduled for oral argument.

If we receive a favorable final decision at the U.S. Court of Appeals level in one or more of the above cases, there will be the requisite split in the Circuits which substantially increases the odds that the Supreme Court will accept a case for review. We are optimistic that such case will be reviewed by the Supreme Court within the next 1 to 2 years and a ruling will be handed down ushering in a new era of regulated market access to wine.

ONGOING CONSUMER PRESSURE TO INITIATE NEW LAWSUITS

During the workshop on "Possible Anti-Competitive Efforts To Restrict Competition on the Internet", Commissioner Swindle raised the issue of the extent to which consumers are actually dissatisfied with current state controls. As Legal Director of CFT, I am frequently contacted by consumers from states which have restrictive direct shipping laws. Generally, these consumers come from states which allow no direct shipping whatsoever or which have such cumbersome regulations that it is virtually impossible for them to receive wine in their state of origin. The affected consumers implore CFT to initiate a lawsuit in their state and usually volunteer to be plaintiffs. Unfortunately, I must tell them that our strategy is first to pursue those states which have statutes that facially discriminate between in-state and out-of-state producers. As discussed previously, the above cases provide the most compelling legal argument for a constitutional challenge in the courts. However, if we receive a favorable decision from the Supreme Court on the existing lawsuits, we will then begin looking at other states with restrictive laws.

CONCLUSION

In conclusion, the combined effect of statutory direct shipping prohibitions and the dearth of available wholesalers is that small and medium sized wineries are effectively precluded from developing and maintaining an out-of-state consumer base. Of course, the ultimate consequence of these conditions is that consumers across the country remain unaware of the existence of thousands of wines and have no ability to purchase them in their home states.

CFT would like to express its gratitude for undertaking this inquiry and encourages the Federal Trade Commission to exert its influence in those states that continue to engage in economic protectionism and restrict consumer choice.