THE CALIFORNIA ABC WINS ONE FOR THE GIPPER'S STATE TIED-HOUSE LAWS

Understanding the U.S. Court of Appeals for the Ninth Circuit's *En Banc* Decision in
Retail Digital Network v. Prieto

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Alcohol regulators across America battle constantly with industry members over trade practices generally, and "tied-house evil" restrictions in particular. At both the federal and state levels, alcohol suppliers and wholesalers generally are prohibited from furnishing funds or items of material value to alcohol beverage retailers, even as they must compete vigorously for the attention and purchasing orders of those retailers. The expanding role of third-party marketers complicates enforcement, as regulators must determine whether upper-tier industry members are doing indirectly what they are prohibited from doing directly.

The ***Retail Digital Network v. Prieto*** case represents a landmark decision in tied-house regulation. The U.S. Court of Appeals for the Ninth Circuit had to balance the commercial speech rights of the alcohol industry under the First Amendment to the U.S. Constitution, against the State of California's police power to regulate alcohol for the health, safety and welfare of the public -- a power enhanced under the Twenty-first Amendment to that same Constitution.

At issue was **Section 25503(f)–(h) of the California Business and Professions Code**, which prohibits an alcohol supplier or wholesaler from directly or indirectly paying a retailer to advertiser the supplier's brands. The regulatory concern is that such payments, whether made directly or through a third party, can lead to prohibited "tied-house evil" inducements.

The case initially was decided by the U.S. District Court for the Central District of California in favor of the state. On appeal to the U.S. Court of Appeals for the Ninth Circuit, a three-judge panel reversed the lower court in favor of the industry plaintiff. California then requested "*en banc*" consideration by all judges of the Ninth Circuit, which was granted.

In a 10-1 decision issued on June 14, 2017, those federal appellate judges reversed the decision of their three fellow judges. The *en banc* panel affirmed the District Court's decision in favor of the State and its tied-house evil prohibition against manufacturers or wholesalers directly or indirectly paying retailers for advertising.

THE UNDERLYING FACTS

The fulcrum on which this teeter-totter of a case was based is Retail Detail Network, LLC (RDN), a middleman involved in the advertising industry. RDN installs liquid crystal displays, or LCDs, in retail stores, including those that sell alcohol beverages. The content displayed on RDN's screens include advertisements.

RDN enters into contracts with suppliers and service providers who want to advertise their products on the displays installed at these retail locations. RDN earns revenue from advertisers. Those advertisers include alcohol beverage manufacturers and suppliers.

The company also enters into contracts with participating retailers for the right to install its LCDs on the retailer's premises. RDN incurs expense by paying each participating retailer "rent" in the form of a percentage of the advertising fees generated by the display in exchange for placing a display in the store.

RDN attempted to enter into contracts with alcohol beverage manufacturers to advertise their brands on RDN's displays in California, but the alcohol manufacturers generally refused due to concerns that the advertising would violate Section 25503(f)–(h) of California's Business and Professions Code. Several alcohol manufacturers and wholesalers, including Anheuser-Busch, Beam Global, Diageo, Jack Daniel's Tennessee Whiskey, MillerCoors and Skyy all refused to contract with RDN because of the same concern.

Section 25503(f)–(h) forbids manufacturers and wholesalers of alcohol beverages from giving anything of value to retailers for advertising their alcoholic products. Thus, for example, a liquor store owner in California can hang a *Captain Morgan Rum* sign in its store window, but Diageo cannot pay the retailer to do so, directly or through an agent.

Twenty-nine years ago, in ***Actmedia, Inc. v. Stroh***, 830 F.2d 957 (9th Cir. 1986), the U.S. Court of Appeals for the Ninth Circuit found this alcohol regulation to be consistent with the First Amendment. Applying the classic four-pronged test for evaluating commercial speech rights under ***Central Hudson Gas & Elec. Corp. v. P.S.C. of New York***, 447 U.S. 557 (1980), the Ninth Circuit determined that the ABC law furthers California's purposes both of limiting the ability of large alcohol beverage manufacturers and wholesalers to achieve vertical and horizontal integration by acquiring influence over the state's retail outlets, and of promoting temperance. The *Actmedia* court ruled that tied-house restrictions on industry members' advertising were permissible so long as the regulation was reasonably tailored to "*prevent manufacturers and wholesalers from circumventing these other tied-house restrictions by claiming that the illegal payments they made to retailers were for 'advertising.'*"

Fast forward 25 years. The current litigation initially was filed by RDN on November 1, 2011, as ***Retail Digital Network LLC v. Applesmith***. After the District Court ruled for the State and RDN appealed, the Ninth Circuit revisited California's tied-house evil restriction on advertising to address whether *Actmedia* remains controlling in light of intervening Supreme Court decisions such as ***Sorrell v. IMS Health, Inc.***, 564 U.S. 552 (2011). RDN argued on appeal that those

cases strengthened its commercial speech rights under the First Amendment. Specifically, the appellant contended that the U.S. Supreme Court stated in *Sorrell* that heightened judicial scrutiny, rather than the standard lower level scrutiny imposed by *Central Hudson*, is warranted "whenever the government creates 'a regulation of speech because of disagreement with the message it conveys.'"

A three-judge panel of Ninth Circuit judges reviewed RDN's appeal in *Retail Digital Network*, accepted the *Sorrell*-based argument and reversed the lower court:

> Consistent with Sorrell's plain language, we rule that *Sorrell* modified the *Central Hudson* test for laws burdening commercial speech. Under *Sorrell*, courts must first determine whether a challenged law burdening nonmisleading commercial speech about legal goods or services is content- or speaker-based. If so, heightened judicial scrutiny is required.

To reach this conclusion, the three-judge appellate panel first held that RDN had standing to challenge Section 25503. The panel then determined that the U.S. Supreme Court's 2011 opinion in *Sorrell* required heightened judicial scrutiny of content-based restrictions on non-misleading commercial speech regarding lawful products, rather than the intermediate scrutiny previously applied to Section 25503 by the Ninth Circuit in its 1986 *Actmedia* decision. The panel held that *Actmedia* was irreconcilable with the Supreme Court's intervening decision in *Sorrell*. The panel therefore reversed the district court's summary judgment, which had found *Actmedia* to be controlling, and remanded on an open record for the District Court to apply *Sorrell's* heightened judicial scrutiny in the first instance.

That decision created something akin to panic in the alcohol regulators of California and across America. Every state has some form of tied-house evil law, and most of the laws prohibit alcohol suppliers from directly or indirectly paying licensed retailers for brand advertising. The potential consequences of the three-judge panel's decision in *Retail Digital Network* were viewed by supporters of traditional alcohol regulation as destabilizing, to say the least.

Which is why, after the three-judge panel issued its opinion, a majority of non-recused active judges voted to rehear this case *en banc*. The case was then briefed and argued before a panel of eleven judges of the U.S. Court of Appeals for the Ninth Circuit.

On June 14, 2017, the Ninth Circuit's *en banc* panel rendered its ruling under the case name *Retail Digital Network LLC v. Prieto* (reflecting Ramona Prieto's status as Acting Director of the California Department of Alcoholic Beverage Control). In a 10-1 decision authored by Judge Richard Paez, with only Chief Judge Sidney R. Thomas dissenting, the federal appellate court affirmed the District Court's original summary judgment in favor of the California Department of Alcoholic Beverage Control. The *en banc* ruling upholds California's tied-house evil law prohibiting alcohol beverage manufacturers and wholesalers from providing anything of value, directly or indirectly, to retailers in exchange for advertising their alcohol beverages.

The *en banc* panel first noted that thirty years ago, in *Actmedia,* the Ninth Circuit rejected a First Amendment challenge to the same California and Professions Code provision. The *en banc* panel

then rejected the plaintiff's contention that *Actmedia* was no longer good law because the Supreme Court's decision in *Sorrell* fundamentally altered the four-part test for evaluating restrictions on commercial speech, established in *Central Hudson*:

> What the Supreme Court repeatedly has declined to do, however, is to fundamentally alter *Central Hudson's* intermediate scrutiny standard. . . . RDN reads *Sorrell* too expansively. Contrary to RDN's argument, *Sorrell* did not mark a fundamental departure from *Central Hudson's* four-factor test, and *Central Hudson* continues to apply.

In explaining why a heightened level of judicial scrutiny was not appropriate in the context of California's tied-house laws, the Ninth Circuit reached an important conclusion that could have significant important for federal and state alcohol regulators across America. In addressing the balance between the government's responsibilities for public safety and the industry's rights to commercial speech, the majority observed:

> There is one other consideration that the Supreme Court acknowledged in *Sorrell* that persuades us that *Central Hudson* continues to set the standard for assessing restrictions on commercial speech. **That consideration centers on one of the core principles that animates the Court's approach to commercial speech—that commercial speech may be subject to greater regulation than non-commercial speech.** *See Sorrell*, 564 U.S. at 579 ("[T]he government's legitimate interest in protecting consumers from 'commercial harms' explains 'why commercial speech can be subject to greater governmental regulation than noncommercial speech.'") (quoting *Discovery Network*, 507 U.S. at 426). **Requiring greater-than-intermediate yet lesser-than-strict scrutiny would both diminish that principle and impose an inscrutable standard.** *See Fox*, 492 U.S. at 477 ("The ample scope of regulatory authority . . . would be illusory if it were subject to a least-restrictive-means requirement, which imposes a heavy burden on the State."). (Emphasis added)

The *en banc* panel expressly held that *Sorrell* did not modify the *Central Hudson* test that been applied in *Actmedia*. However, the majority's ruling also noted that the original justification for the restriction on advertising proffered by the California ABC in the *Actmedia* case – that the law advanced "temperance" – was no longer clearly sufficient when balanced against the industry's commercial speech rights under the First Amendment.

Note that the Ninth Circuit was not rejecting temperance as a legitimate state interest.

Rather, the *en banc* panel determined that Section 25503(h) as written was not drafted to achieve temperance in a sufficiently effective manner relative to the industry's commercial speech rights under the First Amendment. As the majority opinion stated:

> *Actmedia* erroneously concluded that Section 25503(h) directly and materially advances that interest [of promoting temperance] by "reducing the quantity of advertising that is seen in retail establishments selling alcoholic beverages." **Section 25503(h) applies solely to advertising in retail establishments, which comprises a small portion of the alcohol advertising visible to consumers. In addition, it**

> **prohibits only paid advertisements, and therefore, by its terms, does not reduce the quantity of advertisements whatsoever. If California sincerely wanted to materially reduce the quantity of alcohol advertisements viewed by consumers, surely it could have devised a more direct method for doing so**. *Actmedia* otherwise concluded that Section 25503(h) only indirectly advances California's interest in promoting temperance by preventing tied-houses. We agree with that conclusion, but indirect advancement fails to satisfy *Central Hudson's* third factor. We therefore disapprove of *Actmedia's* reliance on promoting temperance as a justification for Section 25503(h). (Emphasis added; citations omitted).

While the *en banc* panel expressly disapproved of *Actmedia*'s reliance on California's interest in promoting temperance as a justification for Section 25503(h), the appellate judges nevertheless ruled that Section 25503(h) withstood First Amendment scrutiny because the advertising restriction "directly and materially advances the State's interest in maintaining a triple-tiered distribution scheme."

> "**As we observed in *Actmedia*, Section 25503(h) addresses the California legislature's specific "concern that advertising payments could be used to conceal illegal payoffs to alcoholic beverage retailers," thereby undermining the triple-tiered distribution scheme**. That concern "appears to have been widely held at the time of [Section 25503(h)'s] enactment . . . . [W]e concur that Section 25503(h) is sufficiently tailored to advance that interest. Section 25503(h) serves the important and narrowly tailored function of preventing manufacturers and wholesalers from exerting undue and undetectable influence over retailers. **Without such a provision, retailers and wholesalers could side-step the triple-tiered distribution scheme by concealing illicit payments under the guise of "advertising" payments. Although RDN argues that the numerous exceptions to Section 25503(f)–(h) undermine its purpose.** RDN fails to recognize that the exceptions do not apply to the vast majority of retailers, and they therefore have a minimal effect on the overall scheme. This stands in stark contrast to cases in which conflicting regulations have rendered the regulatory scheme "irrational," or where the regulatory scheme is "so pierced by exemptions and inconsistencies" that it lacks "coheren[ce]," (Emphasis added; citation omitted).

Not surprisingly, the California Department of Alcoholic Beverage Control was pleased with the outcome of this case. In a formal statement on the matter, the agency's general counsel, Matthew Botting, stated that: "*We are pleased that the en banc court has reaffirmed that California's tied house laws, which regulate relationships between the three tiers of the alcoholic beverage industry, and strike an appropriate balance between commercial speech rights under the First Amendment and the State's need to effectively regulate this unique industry.*

Likewise, supporters of traditional alcohol regulation also responded positively to the *en banc* panel's decision. The National Beer Wholesalers Association (NBWA), along with the Wine and Spirits Wholesalers of America (WSWA), filed an amicus brief in support of the state of California in the *Retail Digital Network* case. The California Beer and Beverage Distributors and the Wine and Spirits Wholesalers of California, Inc., Public Citizen, California Craft Brewers Association and Brewers Association also filed amicus briefs in the case. Following the

decision’s announcement, NBWA President & CEO Craig Purser issued the following statement in response to the ruling:

> *"The 9th Circuit ruling today is a significant win for state-based alcohol regulation and statutes designed to prevent vertical integration and preserve the independence of each tier in the alcohol industry. This is an important decision for responsible alcohol regulation and avoids a dangerous precedent that would have undermined states' primary authority to regulate alcohol."*