A RENEWED CONSERVATISM IN ALCOHOL JURISPRUDENCE

Arnold's Wines, Inc. v. Boyle
Case No. 07-4781-civ
U.S. Court of Appeals for the Second Circuit
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by
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On July 1, 2009, the U.S. Court of Appeals for the Second Circuit weighed in on what has become the classic alcohol law tag-team match of our generation: The Commerce Clause and Direct Shipping vs. The 21st Amendment and the Three-Tier System. Issuing its decision in the case of ***Arnold's Wines, Inc. v. Boyle***, the three federal appellate judges began their unanimous opinion with the following introduction:

> This case asks us to chart a course between two constitutional provisions that delineate the boundaries of a state's power to regulate commerce, one an express grant, the other an implied limitation. Section 2 of the Twenty-first Amendment provides: "The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited." The Commerce Clause reserves for Congress the power "[t]o regulate Commerce . . . among the several States," thus implicitly limiting the states' power to do so. Here, we must determine whether New York's alcohol regulatory regime is properly within the scope of section 2 of the Twenty-first Amendment, such that it does not run afoul of the dormant Commerce Clause.

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To set the stage: The plaintiffs in the *Arnold's Wines Inc.* case are an internet wine retailer and several New York consumers who seek to conduct business with each other directly, outside the requirements of the Empire State's established three-tier system for regulating alcohol. Invoking the U.S. Supreme Court's 2005 decision in *Granholm v. Heald*, the plaintiffs argued that the dormant Commerce Clause of the U.S. Constitution prohibits states from erecting unreasonable, protectionist barriers against interstate trade. According to the plaintiffs, direct shipping should be allowed regardless of whether the out-of-state seller is a winery or a retailer.

The defendants are the New York State Liquor Authority (NYSLA) and interested New York licensees from both the wholesaler and retailer tiers. The defendants countered that the 21st Amendment clearly governs the dispute and expressly empowers the states with broad discretion to regulate the transportation and marketing of alcohol within their respective borders. This broad and decidedly local authority, the defendants argued, legitimizes the NYSLA's insistence that all alcohol sold in New York by retailers must flow through the state's traditional three-tier system.

At the trial court level, the U.S. District Court for the Southern District of New York court ruled for the defendants. Expressly limiting *Granholm* to wineries, U.S. District Judge Richard Holwell ruled that state police powers, strengthened by the 21st Amendment, justified New York's committed reliance on the traditional three-tier system for regulating retail sales of alcohol. According to the District Court: "*Because in-state retailers are the last tier in the State's three-tier system, plaintiffs' challenge to the ABC Law's provisions blocking out-of-state entities from obtaining licenses to compete at this tier is clearly an attack on the three-tier system itself. However, the Supreme Court reaffirmed the constitutionality of the three-tier system in Granholm, and therefore plaintiffs' challenge must fail.*" (Citations omitted).

On appeal, the 2nd Circuit was asked to reverse the lower court's decision on grounds that New York's current 3-tier laws discriminated against out-of-state retailers relative to in-state retailers, much like the pre-*Granholm* version of those laws was found by the Supreme Court to have discriminated against out-of-state wineries relative to New York wineries. After more than a year of deliberation, the federal appellate court rendered its own verdict in the case.

In a unanimous decision authored by Circuit Judge Richard Wesley, the federal appellate court ruled for New York and the traditional 3-tier system. According to the Second Circuit:

> We conclude that the challenged regime is permissible under the Twenty-first Amendment insofar as it requires that all liquor sold within the State of New York pass through New York's three-tier regulatory system.

In rendering this decision, the Second Circuit has produced the strongest precedent in decades for support of traditional alcohol regulation. However, the resulting opinion

emphasizes (a) the absence of facial discrimination -- all retailers technically are treated equally -- plus (b) the "obvious legitimacy" of the traditional three-tier system as declared by the U.S. Supreme Court in *Granholm,* to avoid any substantive analysis of the alleged incidental burden on commerce created by New York's regulation of retailers' alcohol sales. That approach conflicts with the rationale relied on by the U.S. Court of Appeals for the Sixth Circuit in its Direct Shipping case, *Cherry Hill Vineyards, LLC. v Lilly.* It also differs from an approach relied on in part by the U.S. Court of Appeals for the Seventh Circuit in the *Baude v. Heath* case. The result may be a return to the U.S. Supreme Court for clarification on where the balance is struck between Commerce Clause opportunity and 21st Amendment authority.

The Uniqueness of Alcohol and States' Rights

At the crux of the 2nd Circuit's decision is a blend of two conservative themes: (1) a fundamental respect for the uniqueness of alcohol, combined with (2) a reaffirmation of the doctrine of States Rights manifested through the court's deference to New York's three-tier system. The *Arnold's Wines, Inc*. decision restores both these concepts to a position that neither has seen in the past twenty years of alcohol jurisprudence.[2]

Uniqueness is the issue that explains why heavy regulation is justified in the first place. Unlike other consumer goods, the nature of alcohol and its place in the history of the United States seem to render heavy regulation unavoidable. Excess consumption, consumption by minors, consumption and driving, the significant manipulation and domination of retailers by manufacturers, the historical nexus with organized crime – these are but a sampling of concerns commonly cited as justification for state governments to regulate alcohol in ways that tightly control the product's creation, distribution, sale, taxation and consumption. As acknowledged by the concurring opinion issued in this case (discussed in greater detail below):

> When the Twenty-First Amendment was first adopted and courts interpreted section two [of the 21st Amendment] to authorize virtually limitless state regulation, the United States was a different place than it is today. Laws frequently regulated "morals," and alcohol was often viewed as immoral. And even setting "morals" aside, the prevailing view of alcohol was that it was a unique product that posed unusual dangers, both directly as an intoxicant, and indirectly, as a stream of commerce that generated corruption and crime. It was therefore left to individual states to decide, in light of their own local

[2] With one noteworthy exception. I pledged to produce this analysis free of any footnotes, and almost no legal citations. I would be remiss, however, in not giving credit where credit is due to an extraordinary jurist who really does "get it" when it comes to the esoteric area of alcohol law. Judge Frank Easterbrook of the U.S. Court of Appeals for the Seventh Circuit authored the original federal appellate "Direct Shipping" decision in *Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848 (7th Cir. 2000). That decision presented an extensive and detailed history of American jurisprudence as it relates to the regulation of alcohol beverages in America. Although logical in its analysis and substantiated by the "record" of history, Judge Easterbrook's analysis ultimately was passed over by the Supreme Court in favor of the compromise produced by Justice Kennedy's 5-4 majority opinion in *Granholm v. Heald.*

> values, needs, and experiences, how to contend with that product. (Citations omitted).

The Doctrine of States' Rights is relevant as a consequence of the nation's decision in 1933 to allow each state to decide how best to regulate this unique product within its borders, according to the conscience and judgments of its own residents. Although "States' Rights" is not mentioned anywhere in the decision, it is pertinent because adoption of the 21st Amendment to the Constitution codified that state-by-state discretion, and in doing so empowered each of the states with unique rights when regulating this unique product. Again, the concurring opinion in *Arnold's Wines, Inc*. underscores this point by citing a previous concurring opinion authored by Justice Robert Jackson in the U.S. Supreme Court's decision of *Duckworth v. Arkansas*, which emphasized that the authors of the 21st Amendment

> determined that [alcohol] should be governed by a specific and particular constitutional provision. They did not leave it to the courts to devise special distortions of the general rules as to interstate commerce to curb liquor's 'tendency to get out of legal bounds.' It was their unsatisfactory experience with that method that resulted in giving liquor an exclusive place in constitutional law as a commodity whose transportation is governed by a special constitutional provision.

In most of the federal judicial precedents issued over the past decade that address alcohol regulation, these two concepts -- the uniqueness of the product and the right of each state to control it -- have been pushed to the sidelines. Instead, courts to date appear to be embracing a broader, more national and federal approach to alcohol regulation. The trial court decision in the now-famous *Costco Wholesale v. Hoen* case typified that approach to the law, emphasizing a national marketplace and regulation based on federal antitrust laws over localized markets and state regulation.

In contrast, the Second Circuit's new decision in *Arnold's Wine's Inc*. signals a change of direction from that modern thinking. The imaginary pendulum is swinging back towards the 21st Amendment and the original intent of its framers.

The New York System

The 2nd Circuit's decision makes clear that alcohol's uniqueness requires special regulation, and that New York's right as a sovereign state shields its chosen regulatory scheme, *i.e*. the existing 3-tier system. In describing the structure of New York's 3-tier system, the appellate court took pains to explain not only the form but also the function of the state's method for regulating alcohol sales:

> This licensing scheme allows the state to oversee the financial relationships among manufacturers, wholesalers, and retailers, as well as the ways these entities price goods and make sales. The State Liquor Authority may inspect any premises where alcoholic beverages are manufactured, stored, or sold, as

> well as the books and records kept on such premises. New York asserts that the three-tier regulatory system allows the state to collect taxes more efficiently and prevent the sale of alcohol to minors. . .
>
> [Moreover] New York retail off-premises licensees must comply with a set of highly detailed regulations governing the location, physical characteristics, and operating hours of their premises, as well as their financial relationships with producers and wholesalers, and the manner in which they keep books and records for all their transactions. (Citations Omitted).

It is the substantive and extensive function that makes the case for the defendants. At the end of the day, the fact that the licensees are capable of complying with the state's heavy regulation only if they operate within the state is not enough for the Second Circuit. In other words, the extra effort and expense that would be required of out-of-state retailers who sought to comply with New York's 3-tier requirements was not viewed by the *Arnold's Wines, Inc*. court as the kind of discrimination that would justify enjoining enforcement of the state's alcohol laws.

Rather, the incidental impact on out-of-state retailers is the unavoidable cost of deploying a regulatory system deemed necessary by the State of New York to adequately protect the health and welfare of its residents against the unique dangers presented by alcohol. The justification for this conclusion? According to the Second Circuit, it's *Granholm v. Heald*.

Construing Granholm to Shield The State

Going into the case, the plaintiffs relied heavily on *Granholm.* According to Direct Shipping advocates, any state government seeking to restrict interstate sales or deliveries of alcohol outside the traditional 3-tier system of regulation bears a heavy burden when it comes to justifying discrimination that impacts interstate commerce, even if that discrimination is incidental rather than explicit. Although New York's alcohol laws treat all retailers equally on the surface, the plaintiffs argued that compliance placed an unfair burden on them that was not shared by in-state retailers (hence the undue or "incidental" discrimination). The plaintiffs further argued that New York carried the burden of justifying this incidental discrimination.

As most observes will attest, state governments have a poor track record of demonstrating to courts that their alcohol laws are reasonable and justifiable in the face of a Commerce Clause challenge. For better or worse, alcohol laws used to be upheld routinely in the early decades following Prohibition's repeal, simply because the regulations in question involved alcohol. *Granholm*, the plaintiffs in *Arnold's Wines, Inc*. argued, represents the final and ultimate rejection of the notion that state regulation is defensible solely because the product being regulated is alcohol.

Yet, the Second Circuit's decision is based squarely on *Granholm*. In fact, the appellate court turned the plaintiffs' primary weapon against them, citing *Granholm* for the

proposition that the "unquestionably legitimate" nature of the 3-tier system precludes any need to undertake the kind of balancing test previously associated with an incidental discrimination case.

> *Granholm* is best seen as an attempt to harmonize prior Court holdings regarding the power of the states to regulate alcohol within their borders–a power specifically granted to the states by the Twenty-first Amendment–with the broad policy concerns of the Commerce Clause. *Granholm* validates evenhanded state policies regulating the importation and distribution of alcoholic beverages under the Twenty-first Amendment. It is only where states create discriminatory exceptions to the three-tier system, allowing in-state, but not out-of-state, liquor to bypass the three regulatory tiers, that their laws are subject to invalidation based on the Commerce Clause. (Citations omitted).

In *Arnold's Wines, Inc*., the appellate court found that the plaintiffs attempted to "mimic" the concerns addressed in *Granholm* by arguing that New York's prohibition against delivery of wine by unlicensed retailers is invalid because it grants in-state retailers benefits not afforded to out-of-state retailers, *i.e*. the ability to deliver wines purchased by New York consumers directly to the purchaser. The Second Circuit rejected the plaintiffs' arguments for several reasons:

1. Attacking the requirement that all alcohol wholesale distributors and retailers who sell in New York must be present and licensed in the State is an attack on the three-tier system itself, which *Granholm* declared to be "unquestionably legitimate;"

2. The plaintiffs failed to show how New York's 3-tier system treats out-of-state alcohol differently from in-state alcohol. This approach, focusing on the product rather than the players, emphasizes that no cognizable discrimination exists because New York wines are subject to the same 3-tier requirements as out-of-state wines when it comes to distribution and sales to New York consumers. Simply stated, the appellate court found that New York's 3-tier system does not "*discriminate in favor of local products and producers*."

3. Although raised only in a footnote, the appellate court also made clear that the plaintiffs' arguments were unjustified for reasons of practicality as well as jurisprudence. An attack on the 3-tier system that renders it functionally inoperative in the name of equal application is no less acceptable under the 21st Amendment and *Granholm*, according to the Second Circuit. As noted in the deciding opinion's concluding footnote:

> Appellants' complaints of discrimination have somewhat of a hollow ring. Although they assert a willingness to comply with New York's regulatory scheme if allowed to deliver liquor directly to New York consumers, this would be virtually impossible without either an absurd operational result, or a dismantling of New York's entire three-tier scheme. For example, were they to

> comply with the existing system, Indiana-based Arnold Wines would be required to purchase its liquor inventory from New York wholesalers, only to ship the wine back across the country to New York consumers. Even if Appellants were willing to live with this rather absurd arrangement, it would violate Indiana laws requiring licensed liquor retailers to purchase inventory from licensed Indiana wholesalers. But even if Appellants succeed in their challenge to the in-state retailer requirements of New York, under existing New York Law, Arnold's Wines would not qualify for a retail license because multi-store operations are not eligible for retail licenses in New York. Of course, the multi-store operations restriction is written in the context of in-state retailers. Ultimately, because it is demonstrably impossible for out-of-state retailers like Arnold Wines to comply with New York's existing three-tier scheme, granting them the relief they seek would require us to invalidate New York's three-tier system. (Citations omitted).

For those who follow Direct Shipping litigation, the Second Circuit's common sense will stand in sharp contrast with the result reached by the U.S. District Court for the Northern District of Texas *in Siesta Village Market LLC v. Perry.* Recall that in Texas, the court ruled in favor of the plaintiff interstate retailers, acknowledging that Texas beverage laws facially discriminated against out-of-state retailers by not allowing them to deliver to consumers in the way that licensed Texas retailers could. The District Court therefore ordered the Texas Alcohol Beverage Commission to allow out-of-state retailers to apply for licensure, so that they also could do what in-state Texas retailers do.

But, applying that equality literally, the federal court also noted that Texas law requires all retailers to purchase their alcohol beverages from Texas wholesale distributors, and that such a requirement is facially non-discriminatory. Consequently, the District Court also ruled that all out-of-state retailers selling and delivering to Texas consumers in Texas must sell only wines that the interstate retailer purchased from Texas wholesalers. The *Siesta Village Market LLC* decision, and its "absurd operational result" (to borrow the Second Circuit's language) currently is on appeal to the U.S. Court of Appeals for the Fifth Circuit.

The True Force of Arnold's Wine

The *Arnold's Wine, Inc*. case will garner much attention for its bottom-line support of New York's three tier system. However, if the case makes it into the history books as anything other than a footnote, it likely will be as a result of the concurring opinion that accompanies the appellate court's unanimous decision.

It's uncommon for a secondary opinion to outshine the principal decision. But it happens. In the 1927 case of *Whitney v. California*, Justices Louis Brandeis concurred in the U.S. Supreme Court's majority decision upholding a California anti-Communist statute; Brandeis rejected the majority's constricted view of free speech rights, but concurred in the result for other reasons. Few remember the *Whitney* case, which ultimately was overruled by the Supreme Court almost a half-century later. However,

many remember and still cite the Brandeis concurrence in *Whitney* – recognized as one of the most heralded and quoted defenses of free speech and liberty in the Court's history:

> Those who won our independence believed that the final end of the state was to make men free to develop their faculties, and that in its government the deliberative forces should prevail over the arbitrary. They valued liberty both as an end and as a means. They believed liberty to be the secret of happiness and courage to be the secret of liberty. They believed that freedom to think as you will and to speak as you think are means indispensable to the discovery and spread of political truth; that without free speech and assembly discussion would be futile; that with them, discussion affords ordinarily adequate protection against the dissemination of noxious doctrine; that the greatest menace to freedom is an inert people; that public discussion is a political duty; and that this should be a fundamental principle of the American government.

With that concept in mind, special mention deserves to be made of the concurring opinion in *Arnold's Wines, Inc*., authored by Circuit Judge Guido Calabresi. Although acknowledging that he joins "fully" the unanimous opinion authored by Judge Wesley, Judge Calabresi went the extra mile and issued a concurrence to explain how the U.S. Supreme Court over time has "rewritten" the jurisprudence of state power over alcohol and the 21st Amendment to "*accommodate changing social needs and norms*."

The concurring opinion reviews centuries of alcohol law jurisprudence, seeking to differentiate fundamental and enduring principles from transitory and developing trends. The result is a thoughtful and candid assessment of the *de facto* dilution of state power over the regulation of alcohol – a dilution that some conservative observers might criticize as the handiwork of "activist judges" who legislate rather than adjudicate.

Judge Calabresi's concurrence also calls out the *Granholm* court for the inconsistency that has plagued observers since that decision was rendered in 2005:

> Interestingly, however, the [*Granholm*] Court also wrote that its holding would not "call into question the constitutionality of the three-tier system" insofar as "'[t]he Twenty-first Amendment grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system.'" And the Court stated, clear as day, that "the three-tier system itself is 'unquestionably legitimate.'" Indeed, the Court cited Justice Scalia's concurrence in the judgment in *North Dakota* [*v. United States*] and, in an explanatory parenthetical, quoted Justice Scalia's statement that "'The Twenty-first Amendment . . . empowers North Dakota to require that all liquor sold for use in the State be purchased from a licensed in-state wholesaler.'" The Court, however, concluded this affirmation of the three-tier system by stating that "[s]tate policies are protected under the Twenty-first Amendment when they treat liquor produced out of state the same as its domestic equivalent" but that "[t]he instant cases, in contrast, involve straightforward attempts to discriminate in favor of local producers." . . .

> It is possible that the Twenty-First Amendment was originally intended and understood to have the complex shape that it has assumed in the past few decades. But, as many distinguished justices have contended—initially in opinions for the Court and more recently in dissent—it seems more likely that the Twenty-First Amendment, when enacted, meant to carve out from dormant Commerce Clause scrutiny the area of alcohol regulation. Nevertheless, it appears that the Supreme Court has increasingly "updated" the Twenty-First Amendment . . . (Citations omitted).

Ultimately, the power of Judge Calabresi's concurrence lies in the voice it gives to the sober and legitimate concerns of judges, lawyers, regulators, and even industry members who question how the modern jurisprudence is affecting the rights of a state and its populace to decide for themselves how best to regulate within their own communities the unique product that is alcohol. Certainly, the Internet, e-commerce and nationwide overnight delivery were unknown 75 years ago. Likewise, many modern social conventions and attitudes that are commonly accepted today would have produced shock and apoplexy in the early Twentieth Century. Conversely, concepts such as "temperance" often are viewed today with misunderstanding and ignorance, if not outright disdain.

But who decides how best to bridge that gulf between then and now when the Constitution is at issue? According to Judge Calabresi, this is no easy question:

> Interpreting the *Constitution*, with respect to out-of-date constitutional provisions, presents a more complex set of challenges. Because the U.S. Constitution is so difficult to amend, a provision that has become anachronistic is even less likely to be repaired by the political branches than is an out-of-date statute. But while courts may, perhaps, be viewed as engaging in a dialogue with the political branches when "updating" anachronistic statutes through "interpretation," such a dialogue is far more difficult and dangerous in the context of constitutional law. For a court cannot easily assume that the political branches will be able correct even egregious constitutional interpretative errors. Some constitutional provisions were written to evolve over time. The Eighth Amendment's prohibition on cruel and unusual punishment would mean little if courts were expected simply to comb through history books and determine what, in the late eighteenth century, the framers thought was "cruel." The Fourth Amendment's prohibition on "unreasonable" searches similarly permits evolution and prevents that constitutional provision from becoming tethered to another time. Conversely, some provisions were not written to be updated. The President of the United States must be at least 35 years old. That number is not to be "inflation adjusted." But what are courts to do when a constitutional provision neither clearly invites nor clearly prohibits updating? (Citation and footnote omitted).

To his credit, Judge Calabresi is a jurist who minds his place. His concurrence makes clear that such questions are the province of the nation's highest court, rather than his own Second Circuit bench.

Yet, also to his credit, this federal appellate judge (along with his colleagues) does not abdicate the responsibility to deliver a reasoned decision on the case at bar, the absence of clear and unambiguous precedents notwithstanding. As he concludes his concurrence, Judge Calabresi paints a fairly clear picture of the road that lies ahead for alcohol law jurisprudence generally, and Direct Shipping litigation in particular:

> [T]he best that we can do is to look to the bulk of cases decided by the Supreme Court and read with special care its latest decision—at the moment, *Granholm*. For, while the general direction of Supreme Court jurisprudence has been toward prohibiting any discriminatory state regulation, it is not for our court to say how far or how fast we should move along that vector. As a result, we must look to the run of Supreme Court cases that have permitted broad state regulation, and then consider the existing exceptions, particularly those both described and limited in the recent controlling *Granholm* case, and, on that basis, decide.

Pretty good advice for everybody –regulators, industry members, judges and lawyers alike – as the saga of alcohol in America continues on.