

DOES SIZE MATTER?

Family Winemakers of California v. Massachusetts

A Federal Appellate Court Declares Massachusetts' 30,000 Gallonage Cap On Wineries That Direct Ship To Be An Impermissible Burden On Interstate Commerce, and Further Shrinks the Legal Enhancement Afforded State Alcohol Regulation by The 21st Amendment.

By

Richard M. Blau, Esq.¹

GRAY | ROBINSON
ATTORNEYS AT LAW



On January 14, 2010, the U.S. Court of Appeals for the First Circuit issued the new decade's first "Direct Shipping" decision. *Family Winemakers of California v. Jenkins* is a case which challenged Massachusetts' law requiring wineries that produce more than 30,000 gallons of grape wine annually to choose between: (1) distributing their products only through licensed wholesalers within the state's traditional three-tier system, or (2) selling their products only directly to Massachusetts consumers. A federal trial court determined in 2008 that the Massachusetts law violated the dormant Commerce Clause of the U.S. Constitution by discriminatorily-impacting out-of-state wineries in effect, even though the law was location-neutral on its face. The federal appellate court has now affirmed that conclusion, and in doing so expressed a narrow construction of the 21st Amendment that is less supportive of states' rights to regulate alcohol than any previous judicial precedent in recent memory.

¹ Mr. Blau is a shareholder in GrayRobinson P.A., and presides over the firm's *Alcohol Industry Team*, representing clients in connection with the rules and regulations that govern the production, marketing, sale, and consumption of distilled spirits, wine, beer, and other licensed beverages. Mr. Blau served for eight years as the Chairman of the American Bar Association's Committee on Beverage Alcohol Practice, and lectures regularly on Twenty-first Amendment and alcohol liability issues.

Background:

Like many states across America, Massachusetts historically has taken a schizophrenic approach to alcohol regulation when it comes to small farm wineries. For more than a generation, the Commonwealth required conventional grape wines -- the commercial wines sold in package stores and grocery stores as well as restaurants and bars throughout the states and across the country -- to pass through the traditional three-tier system of regulation before reaching a Massachusetts consumer. However, Massachusetts simultaneously allowed grape and orchard fruit farm wines produced by local, small-operation farmers to be sold directly to consumers and retailers, as well as distributed by wholesalers through the traditional three-tier system.

The “native farm winery” exception to the traditional three-tier system, which became popular throughout America during the latter half of the 20th Century, makes no sense when viewed solely in the context of alcohol regulation. Alcohol that is sold outside the traditional three-tier system lacks the “orderly market” protections afforded by:

- multiple levels of licensee oversight and control;
- the efficient collection of taxes by a single tier of licensees, subject to direct and in-person inspection by state auditors and regulators;
- the in-person purchaser verifications by licensees that reduce the risk of illegal sales to minors; and
- the proximate accountability between the retail vendor and the consumer community that can support responsible retail vending behaviors, while deterring irresponsible retail vending behaviors that produce local secondary affects.

Why, then, have so many states compromised their three-tier systems with these native farm winery exceptions?

The decision to allow small farm wineries to “self-distribute” reflects a common political compromise harmonizing the competing interests of alcohol regulation and agricultural promotion. Almost every state in America with an agricultural population of any cognizable size, including Massachusetts, has provided for such an exception.² Farming has never been easy, and in the 20th Century smaller family farms found it increasingly difficult to operate profitably. Legislators deemed these farm winery exceptions as

² As a random sampling to demonstrate the geographic scope of the native farm winery exception to traditional alcohol regulation, *see, e.g.* § 28-6-1, *et seq.*, Ala. Code (codifying The Alabama Native Farm Winery Act of 1979 that was in place for over 20 years before being repealed); §561.221(1)(b), Fla. Stat. (creating the Florida Farm Winery permit); §53-103, Neb. Rev. Stat. (Creating farm winery provision in Nebraska Liquor Code for producers based in the state who use local agricultural products to produce wine); §33:1-10, N.J. Code (creating the New Jersey Farm Winery license for producers operating under a 50,000 gallonage cap); §60-6A-11, N.M. Stat. (creating New Mexico’s farm winery exception for producers who use local agricultural products to make at least 50% of annual wine output); §§ 60-1-5a, 60-3-25, W. Va. Code (establishing the West Virginia Farm winery exception for in-state wineries that make products from at least 75% local ingredients to self-distribute).

necessary tools to support and encourage small farmers who generate farm income, either as their primary crop or as supplementary revenue, through the production and sale of limited quantities of farm wine.

Litigation over these farm winery exceptions started in the late-1990s, after California-led efforts to promote “reciprocal shipping” laws had run their course with limited success.³ The Internet allowed winery and wine-consumer advocates to join forces and strategize on ways to use lawsuits to overcome state laws that frustrated interstate sales of wine. These Direct Shipping Lawsuits targeted state farm winery laws that discriminated against out-of-state producers by extending the privilege of selling outside the state’s three-tier system only to in-state producers. Plaintiffs argued that such discrimination violated the dormant Commerce Clause of the U.S. Constitution.

The Direct Shipping Lawsuits initially culminated in 2005, with the U.S. Supreme Court’s decision in *Granholm v. Heald*.⁴ In that decision, the justices held by a thin 5-4 majority that the Commerce Clause prohibits states from passing laws which on their face discriminate against out-of-state wineries relative to in-state wineries. Although the Court acknowledged that the traditional three-tier system of alcohol regulation employed by states across America was “unquestionably legitimate,” it also ruled that the 21st Amendment would not immunize blatant discrimination that unquestionably and materially burdened interstate commerce.

As a result of the *Granholm* decision, many states revised their farm winery exception laws. One group of states “leveled up” so that out-of-state wineries received the same privileges as their in-state counterparts.⁵ A second group of states “leveled down” so that nobody, in or outside the state, could sell and ship alcohol in that state outside its established three-tier system.⁶

A third group of states followed a more complicated path. These states had multiple objectives, *i.e.*: (a) to continue allowing small farm wineries to self-distribute their farm wines, while (b) complying with the Supreme Court’s dictates in *Granholm*, and (c)

³ Initially, winery interests seeking to overcome state laws prohibiting direct wine sales and shipping sought legislative solutions by lobbying for the adoption of reciprocal shipping laws – *i.e.* laws that allowed wineries in a state to sell and ship directly to consumers in any other state that afforded reciprocal privileges. These reciprocal law campaigns began with California in 1985, and over the ensuing decade successfully produced the adoption of reciprocal laws in 12 additional states. However, when lobbying for a legislative solution produced no additional reciprocal states, tactics changed and legislative strategies were replaced with litigation strategies. Thus was the era of the Direct Shipping Lawsuits begun.

⁴ 544 U.S. 460, 489 (2005).

⁵ States that legislatively liberalized access to their markets for out-of-state wineries following the *Granholm* decision include: Connecticut, Indiana, Kansas, Michigan, New York, Ohio, Rhode Island, Texas and Vermont.

⁶ States that prohibit any direct shipment of alcohol to consumers outside the traditional three-tier system regardless of the supplier’s location include: Alabama, Delaware, Maine, Maryland, Mississippi, Montana, New Jersey, Oklahoma, South Dakota, Tennessee, and Utah.

ensuring that the public received the benefits of having the vast majority of wine sold and consumed within the state pass through that state's three-tier system. This third group of states extended direct sales and shipping rights to all wineries, in-state and out-of-state, but only based on qualifications. The two most common qualifications for direct shipping rights in these states were face-to-face transaction requirements and maximum production gallonage caps.⁷

Massachusetts joined the third group of states. In 2006, after a local federal court had found its existing farm winery law to be unconstitutional under *Granholm*,⁸ Massachusetts went the gallonage-cap route. The Massachusetts legislature amended its direct shipping law to allow for all "small wineries," those that produced 30,000 gallons or less of grape wine per year, to distribute through the three-tier system as well as self-distribute to Massachusetts retailers and consumers.⁹ The same law, however, required "large wineries," those producing more than 30,000 gallons of grape wine per year, to opt for one of two distribution methods: either rely solely on distribution through Massachusetts' three-tier system of licensed wholesalers, or sell only on a direct shipping basis to Massachusetts consumers (but not to Massachusetts wholesalers or retailers).

The Massachusetts law was location-neutral on its face. However, the facts on the ground, which were blatantly displayed throughout the new law's legislative history, reveal that Massachusetts at the time of the law's passage had no wineries that produced more than 30,000 gallons of grape wine per year.

California wineries and wine consumers cried "foul," claiming that the new law was protectionist legislation in intent and effect. Critics pointed out that there was one winery in the commonwealth which came close to producing 30,000 gallons of wine each year, when the total included grape plus other orchard fruit wines such as apple wine; to save this winery from "large" status, Massachusetts legislators intentionally fine-tuned the new law to exclude from the gallonage cap calculus any wines made from fruit other than grapes.

In addition to an impermissible intent, critics also argued the new law had the effect of forcing significant numbers of out-of-state wineries to make a Devil's choice between selling only to Massachusetts wholesalers or selling only to Massachusetts consumers, while allowing all Massachusetts wineries to reap the benefits of selling to Massachusetts wholesalers, retailers and consumers. In short, these California wineries argued that the new law was discriminatory in purpose and effect, even if it was location-neutral on its face.

⁷ Examples of states in this third group include: Arizona (adopting a 30,000 gallonage cap plus a face-to-face transaction requirement to qualify for direct shipping privileges); Indiana (leveling up but requiring a face-to-face transaction); Kansas (requiring a face-to-face transaction); Kentucky (adopting a 50,000 gallonage cap); Massachusetts (adopting a 30,000 gallonage cap); Ohio (adopting a 250,000 gallonage cap); Rhode Island (requiring a face-to-face transaction).

⁸ *Stonington Vineyards v. Jenkins*, No. 05-10982-JLT, slip op. at 1-2 (D. Mass. Oct. 5, 2005).

⁹ Mass. Gen. Laws ch. 138, §19F (a).

The California wineries, joined by concerned wine consumers, sued the commonwealth in 2007 claiming that the new Massachusetts law was an unconstitutional burden on interstate commerce. Family Winemakers of California and assorted other plaintiffs sued the head of Massachusetts Alcoholic Beverage Control Commission (ABCC) alleging that the new law discriminated against out-of-state wineries and unconstitutionally burdened interstate commerce in violation of the dormant Commerce Clause. The plaintiffs' [complaint](#) cited to numerous instances in the legislative record demonstrating that Massachusetts lawmakers expressly designed Section 19F to make sure no Massachusetts wine producers fit within the definition of a "large" winery, thus putting all of the law's burdens on out-of-state producers.

In 2008, a federal trial court decided *Family Winemakers of California v. Jenkins* in favor of the plaintiffs. The trial court based its decision on a record replete with evidence that Massachusetts legislators designed the new wine law to protect Massachusetts wineries. Indeed, Federal District Judge Rya Zobel's [decision](#) cited extensively from the legislative record, noting numerous blatant examples of parochial economic protectionism, before concluding:

[T]he sequence of events leading up to the passage of the bill and the public comments by the bill's sponsor, detailed *supra*, provide strong support for plaintiffs' assertion that § 19F was designed to allow all in-state wineries to continue direct shipping while forcing the majority of interstate wine to go through the three-tier system, thereby preserving the economic interests of both Massachusetts wholesalers and Massachusetts wineries. The most damning evidence is the exemption for fruit wine, which has no stated purpose or rationale but benefits Nashoba Valley, the only in-state winery which – absent the exemption – would approach the 30,000 gallonage cap. . .

It is further notable that § 19F permits "large" wineries to choose only between selling to wholesalers and selling directly to consumers, while "small" wineries may sell to wholesalers, retailers, restaurants and consumers. Accordingly, even if a "large" winery were willing to undertake the expense and effort of selling its wine without a wholesaler, under the statute there is no set of circumstances under which it could sell to retailers and restaurants, making it even more unlikely that a "large" winery would ever choose the direct shipping option. Finally, the statute's sponsor explicitly stated, "with the limitations that we are suggesting in the legislation, we are really still giving an inherent advantage indirectly to the local wineries."¹⁰

Massachusetts subsequently appealed to the U.S. Court of Appeals for the First Circuit. The commonwealth might have been hoping that the appellate court would rule for the

¹⁰ *Family Winemakers of Cal. v. Jenkins*, No. 1:06-cv-11682-RWZ at 17-28 (D. Mass. Nov. 19, 2008).

government as it had in *Cherry Hill Vineyard LLC v. Baldacci*,¹¹ where a Commerce Clause challenge to Maine's wine laws requiring face-to-face transactions was defeated because the plaintiffs failed to meet their burden of proof with evidence showing that the law benefited Maine vineyards or harmed out-of-state wineries.¹² That hope, however, proved unfounded.

What The First Circuit Said:

The First Circuit's [opinion](#) was a home run for the plaintiffs. The appellate court ruled that the Massachusetts wine law violated the Commerce Clause, finding that both the intent and the effect of the law were to protect Massachusetts wineries to the detriment of out-of-state wineries. More importantly, the First Circuit created a new precedent for construing the 21st Amendment, extending the previously doctrines enunciated by the U.S. Supreme Court in *Granholm* as well as its own prior precedent in *Baldacci* to further erode the states' rights to regulate alcohol.

In summarizing its decision for the plaintiffs in *Family Winemakers of California v. Jenkins*, the First Circuit stated:

We hold that § 19F violates the Commerce Clause because the effect of its particular gallonage cap is to change the competitive balance between in-state and out-of-state wineries in a way that benefits Massachusetts's wineries and significantly burdens out-of-state competitors. Massachusetts has used its 30,000 gallon grape wine cap to expand the distribution options available to "small" wineries, including all Massachusetts wineries, but not to similarly situated "large" wineries, all of which are outside Massachusetts. The advantages afforded to "small" wineries by these expanded distribution options bear little relation to the market challenges caused by the relative sizes of the wineries. Section 19F's statutory context, legislative history, and other factors also yield the unavoidable conclusion that this discrimination was purposeful. Nor does § 19F serve any legitimate local purpose that cannot be furthered by a non-discriminatory alternative.

We further hold that the Twenty-first Amendment cannot save § 19F from invalidation under the Commerce Clause. Section 2 of the Twenty-first Amendment does not exempt or otherwise immunize facially neutral but discriminatory state alcohol laws like § 19F from scrutiny under the Commerce Clause. We affirm the grant of injunctive relief.

¹¹ 505 F.3d 28 (1st Cir. 2007).

¹² *Baldacci* addressed the evidentiary burden required when a plaintiff invokes the Commerce Clause to challenge the constitutionality of a state alcohol statute, asserting that the law is discriminatory in effect even though it is non-discriminatory in purpose. 505 F.3d at 36-38.

The true significance of the decision lies beneath this summary and within the depths of the opinion where several legal conclusions and jurisprudential observations appear to recalibrate the balance between the alcohol industry's commercial rights to access markets free from parochial discrimination, and the states' rights to regulate alcohol in a manner that adequately achieves legitimate public purposes. Absent further appeal to the U.S. Supreme Court, *Family Winemakers of California v. Jenkins* will provide great comfort for industry members seeking to overcome state obstacles to a national marketplace for wine, and impose significantly greater evidentiary burdens on state alcohol regulators to demonstrate the legitimacy of their laws.

What's So Significant About This Court Decision?

There are four key components to the appellate court's decision in *Family Winemakers of California v. Jenkins* that are worthy of special scrutiny. They can be summarized as follows:

1. Even if a state alcohol law does not discriminate between in-state and out-of-state industry members on its face, it still can impermissibly burden interstate commerce if its intent and effect are shown to impair the ability of some (not all) out-of-state interests to compete against in-state competitors while leaving all the in-state industry members free to compete without burden. Stated another way, gallonage caps that discriminate only between small and large wineries, regardless of location, nevertheless can violate the dormant Commerce Clause if the plaintiff can show through competent evidence that: (a) all wineries, big and small, are competing in the same product market, (b) none of the in-state wineries are negatively affected by the caps, but (c) the caps as applied have the effect of imposing burdens that impede some of the out-of-state wineries (the large ones) from competing on a level playing field with their in-state competitors.
2. The government cannot sustain its discriminatory laws without producing competent evidence demonstrating that legitimate objectives are being achieved in the least-intrusive or restrictive way possible. Stated another way, once the plaintiff shows that a state alcohol law -- even one that is location-neutral on its face -- has a discriminatory impact on interstate commerce, the state carries the burden of proving that its law: (a) is directed at achieving legitimate public purposes, (b) achieves those stated purposes, and (b) operates in the least restrictive way possible.
3. In ruling that the plaintiffs met their burden of proof, the First Circuit accepted the assumption that "large" and "small" wineries compete in the same market. The First Circuit either did not hear or was not persuaded by arguments that were based on: (a) policies that have motivated alcohol regulators at the federal and state levels to treat smaller licensees differently from their larger competitors since the repeal of Prohibition, and (b) an economic and common sense perception that conventional grape wines are commercialized differently, and represent a different product market, from small farm wines.

4. The balancing of evidentiary burdens articulated by the First Circuit goes beyond the decision in *Granholm v. Heald*, and restates alcohol law under the 21st Amendment. Specifically, the *Family Winemakers of California v. Jenkins* decision by the First Circuit is a precedent that can be argued for the following:
- a. *Granholm* dealt with a wine law that discriminated against out-of-state wineries in favor of local wineries on its face. The First Circuit takes this one step further, dealing with a wine law that does not discriminate based on location, but nevertheless produces an impact that affects some outsiders while protecting all insiders. According to the First Circuit, the 21st Amendment does not exempt facially neutral state alcohol laws with discriminatory effects from the non-discrimination rule of the Commerce Clause; nor are such laws exempt when they also discriminate by design to promote local economic protectionism.
 - b. The Twenty-first Amendment does not lessen the “rigorous” degree of Commerce Clause scrutiny for facially neutral but discriminatory state alcohol laws to mere rational basis review. According to established Supreme Court standards, including a precedent cited by the First Circuit, an ordinance that discriminates on its face against interstate commerce and in favor of local businesses is per se invalid, “save in a narrow class of cases in which the municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest.”¹³ The Supreme Court also has held that if an ordinance is not discriminatory on its face, a balancing test must then be performed to determine its constitutionality.¹⁴ Viewed in this less intense light, the facially neutral ordinance will stand unless the burden that it places upon interstate commerce is “clearly excessive in relation to the putative local benefits.”¹⁵ Moreover, the U.S. Supreme Court in *Pike v. Bruce Church, Inc.*,¹⁶ stated that “[w]here the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. . . . If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.”¹⁷

¹³ *C&A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 392 (1994).

¹⁴ *See id.* at 390.

¹⁵ *Id.* (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970)).

¹⁶ 397 U.S. 137, 142 (1970).

¹⁷ *Id.* (citation omitted).

The First Circuit expands on this Supreme Court doctrine to declare that if a plaintiff carries its burden of proving that a facially neutral law is discriminatory in effect, then "[t]he state bears the burden of showing legitimate local purposes and the lack of non-discriminatory alternatives, and discriminatory state laws rarely satisfy this exacting standard." Beyond that, the First Circuit also concludes that once discriminatory impact is established, then no further balancing test under *Pike* is required relative to legitimate public purposes served by the law: "Because we hold that § 19F discriminates against interstate commerce, it is unnecessary for us to decide whether § 19F would also violate the Commerce Clause under *Pike*."

- c. Arguments based on the "core powers of the 21st Amendment," *i.e.* "promoting temperance, ensuring orderly market conditions, and raising revenue" to uphold a state alcohol law despite its discriminatory effect and design may no longer be cognizable, much less sufficient to outweigh the Commerce Clause principles that would otherwise be offended.

Bad Facts Can Make Bad Law:

A core component of the First Circuit's decision is the appellate court's finding that: "Section 19F's statutory context, legislative history, and other factors also yield the unavoidable conclusion that this discrimination was purposeful." Admittedly, the record before the appellate court was pretty bad -- replete with evidence that the Massachusetts Legislature intentionally passed its gallonage cap to protect local farm wineries.

Prior to 2005, Section 19B of Chapter 138 of the Massachusetts General Laws, which codified the commonwealth's farmer-winery licensing law. On its face, that law allowed only in-state wineries to obtain licenses to combine distribution methods through wholesalers, retailers, and direct shipping to consumers.¹⁸ Five months after *Granholm v. Heald*¹⁹ invalidated similar facially discriminatory state laws from Michigan and New York, a federal court in Massachusetts found Section 19B to be invalid under the Commerce Clause.²⁰ In 2006, the Massachusetts legislature enacted Section 19F to replace its unconstitutional predecessor.

Section 19F does not distinguish on its face between in-state and out-of-state wineries in terms of eligibility for a Massachusetts-issued direct shipping license. Instead, the exception to Massachusetts' three-tier system distinguishes between "small" or "large" wineries based on a 30,000 gallonage cap for conventional grape wine production; wine or wine product fermented from other than grapes is not counted towards the 30,000 gallon figure.

¹⁸ Mass. Gen. Laws ch. 138, § 19B (2002).

¹⁹ 544 U.S. 460, 489 (2005).

²⁰ *Stonington Vineyards v. Jenkins*, No. 05-10982-JLT, slip op. at 1-2 (D. Mass. Oct. 5, 2005).

Under the new Section 19F, a “small” winery based anywhere in America is allowed to sell its grape and orchard fruit farm wines direct to Massachusetts retailers and consumers while also using in-state wholesale distributors to build a Massachusetts market for its products. A “large” winery, in contrast, may sell wine directly to Massachusetts consumers only if it *“has not contracted with or has not been represented by a wholesaler licensed under section 18 for the preceding 6 months.”*²¹ Thus, large wineries, regardless of their geographic location, face a Devil’s choice when it comes to making alcohol sales in Massachusetts: either continue to use Massachusetts wholesalers and forego direct shipping to Massachusetts consumers, or engage in direct shipping to consumers but forego sales to wholesaler distributors or retailers.

The critical fact from the First Circuit’s view was that at all times relevant to the litigation there were no “large” wineries in Massachusetts that produce over 30,000 gallons per year of grape wine. Thus, although Section 19F applied equally to large wineries regardless of their location, the uncontested reality was and apparently remains that there are no “large” Massachusetts wineries.

Section 19F’s large winery/small winery structure apparently was based on the Massachusetts legislature’s desire to balance alcohol regulation with agricultural promotion. According to statistics presented during litigation over the new law, ninety-eight percent (98%) of the conventional grape wine sold in America is produced by wineries that Section 19F defines as “large.” In order to bolster small farmers who produce farm wines while continuing to keep the majority of conventional grape wine sold in Massachusetts flowing through the commonwealth’s three-tier system, the Massachusetts legislature concluded that producers making more than 30,000 gallons of grape wine per year had to be limited legislatively in their ability to direct ship their products to Massachusetts residents.

By allowing “large” wineries either to direct ship or wholesale distribute, but not both, Section 19F sought to steer the vast majority of wine purchases (over 90% according to the First Circuit) into its traditional three-tier system, while still allowing the producer to make the decision on which distribution channel to select. The expectation that large wineries would stick with state distributors was a rational one for two reasons: first, in 2006 when Section 19F was enacted, grape wines from the nation’s 30 largest wineries accounted for ninety-two percent (92%) of the total wines sold in America, and those wines were distributed by wholesalers; second, Section 19F limited any large winery that opted for direct shipping to consumer sales only, meaning that the winery would lose the ability to sell to wholesale distributors and licensed retail vendors (restrictions not imposed on any small wineries).

Perhaps what also should have been rationally expected was a second lawsuit against Massachusetts’ direct shipping laws, this time aimed at Section 19F. Apparently, the Massachusetts Legislature had no such expectation. How else would anyone explain a

²¹ Mass. Gen. Laws ch. 138, §19F (a).

legislative record with prejudicial statements like this on-the-record quote from State Senator Morrissey, which was recited in the *Family Winemakers of California v. Jenkins* trial court's decision:

Senator Morrissey concluded the discussion by noting: "But everybody can do business here now. And ironically, with the limitations that we are suggesting in the legislation, we are really still giving an inherent advantage indirectly to the local wineries."²²

Not surprisingly, these and other statements made by a handful of legislators during the legislative process that produced Section 19F were a central pillar of the plaintiffs' lawsuit, as well as the district and appellate court decisions that ruled in their favor. As the First Circuit noted in its decision:

During floor debates, § 19F's sponsor summed up § 19F as follows: "[W]ith the limitations that we are suggesting in the legislation, we are really still giving an inherent advantage indirectly to the local wineries." Likewise, the state senator whose district included Massachusetts's then-largest winery explained his qualified support for § 19F by stating that "the agricultural industry here in Massachusetts is really strong and should be preserved. And we do this . . . because we produce these specialty goods, pick-your-own orchards and wineries." The senator had another concern--that the winery in question, which primarily produced fruit wine, "comes close to the 30,000 [gallon] production limit" for "small" wineries and would likely soon exceed it because "it's a winery that is growing . . . and certainly uses wholesalers in other states." The senator urged modifications to § 19F because "we should be promoting this kind of industry and not adopting regulations, however inadvertently, that might take away the advantage that the winery would have." The draft of § 19F was amended shortly thereafter to exempt non-grape fruit wine production from the 30,000 gallon cap, and that version was enacted.

Unfortunately, a bad record can lead to a bad decision. In past precedents, the First Circuit was willing to uphold state laws that were facially neutral, on the theory that legitimate state interests justified incidental impact on interstate commerce. For example, in 2007 the First Circuit upheld Rhode Island's limitation on franchise and chain stores' ability to sell alcohol beverages as retail licensees. Ruling against a Commerce Clause challenge to the Rhode Island law that clearly was intended to protect Mom & Pop retailers against large chain competitors, the appellate court ruled in *Wine and Spirits Retailers, Inc. v. Rhode Island* that:

[T]he most that the plaintiffs have shown is that the neutral, evenhanded requirements that we have been discussing incidentally burden

²² *Family Winemakers of Cal. v. Jenkins*, No. 1:06-cv-11682-RWZ at 13 (D. Mass. Nov. 19, 2008).

interstate commerce by precluding various methods of distribution in the retail liquor market. That is not enough. In order to invalidate the requirements, any such burden would have to be "clearly excessive in relation to the putative local benefits." Pike, 397 U.S. at 142, 90 S.Ct. 844.

Here, the hoped-for local benefits consist primarily of regulating and safeguarding against anticompetitive behavior in the retail liquor market. See R.I. Gen. Laws § 3-5-11.1; see also Heald, 544 U.S. at 488-89, 125 S.Ct. 1885; Wine & Spirits, 418 F.3d at 51, 54. The corresponding burdens on interstate commerce are minimal. Again leaving to one side the residency requirements, see supra Part III(A), the plaintiffs have identified only two conceivable burdens: a loss of flexibility in arranging business affairs and a less-than-optimally-efficient distribution system for alcoholic beverages that have traveled through interstate commerce. Even accepting that these are real burdens, the plaintiffs have the obligation of proving excessiveness, see Pharm. Care Mgmt. Ass'n, 429 F.3d at 313--and they have not come close to showing that the burdens they envision are excessive in relation to the statutory scheme's legitimate goals.

We need not tarry. The Supreme Court previously has rejected the notion that the dormant commerce clause protects particular business structures or methods of operation in retail markets. See Exxon, 437 U.S. at 127, 98 S.Ct. 2207. The plaintiffs' argument that consumers would be advantaged by unregulated competition in retail liquor sales, like the argument rejected in Exxon, "relates to the wisdom of the statute, not to its burden on commerce." Id. at 128, 98 S.Ct. 2207. It is, therefore, of little moment. The bottom line is that the plaintiffs have failed to prove a violation of the dormant commerce clause.²³

Why the sea change in approach to measuring the impact of alcohol regulations on interstate commerce? The significant attention paid by both the trial and appellate courts to the machinations of Section 19F's legislative history suggests that there was too much funny business to ignore. Whether justified or not, that sentiment permeates both decisions, and may account at least in part for why Massachusetts came up short in this case.

Getting the Burden of Proof Right:

In *Granholm v. Heald*, the U.S. Supreme Court ruled that the 21st Amendment does not immunize an alcohol regulation that discriminates on its face against out-of-state parties

²³ *Wine and Spirits Retailers, Inc. v. Rhode Island*, 481 F.3d 1, 15-16 (1st Cir. 2007).

and unduly burdens interstate commerce. The appellate court in *Family Winemakers of California v. Jenkins* has taken that concept one step further:

We further hold that the Twenty-first Amendment cannot save § 19F from invalidation under the Commerce Clause. Section of the Twenty-first Amendment does not exempt or otherwise immunize facially neutral but discriminatory state alcohol laws like § 19F from scrutiny under the Commerce Clause. (Emphasis added).

In this case, the First Circuit found that Section 19F was neutral on its face, but discriminatory in its effect. The appellate court expressly relied on the following legal maxim: “A state law is discriminatory in effect when, in practice, it affects similarly situated entities in a market by imposing disproportionate burdens on out-of-state interests and conferring advantages upon in-state interests.”

It is important to note, that in assessing the legality of state regulations that are facially neutral but allegedly discriminatory in effect, the burden is on the plaintiff challenging the law. Specifically, in legal challenges where the law is on its face non-discriminatory and serves legitimate regulatory objectives, it will be adjudicated invalid only if the challenger first shows through competent evidence that (a) the state law actually harms interstate commerce in a material way, and (b) that such harm is out of proportion to the purported local benefit.²⁴ Viewed in this less rigorous level of scrutiny, the facially neutral ordinance generally will stand unless the burden that it places upon interstate commerce is “clearly excessive in relation to the putative local benefits.”²⁵

As the U.S. Supreme Court stated in *Pike v. Bruce Church, Inc.*:

Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. . .

If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.²⁶

Moreover, as the First Circuit itself has ruled in a prior precedent:

²⁴ See *C&A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. at 390.

²⁵ *Id.* (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970)).

²⁶ 397 U.S. 137, 142 (1970).

Applying the Pike balancing test to the Maine Act, we consider: (1) the nature of the putative local benefits advanced by the statute; (2) the burden the statute places on interstate commerce; and (3) whether the burden is "clearly excessive" as compared to the putative local benefits. See *Pike*, 397 U.S. at 142, 90 S.Ct. 844.²⁷

That requirement of competent evidence cannot be speculative, and cannot rest just on lawyer talk. As another federal appellate court reasoned when reviewing a challenge to Indiana's direct shipping laws:

Any balancing approach, of which *Pike* is an example, requires evidence. See *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456 (1981). It is impossible to tell whether a burden on interstate commerce is "clearly excessive in relation to the putative local benefits" without understanding the magnitude of both burdens and benefits. See *Cherry Hill Vineyard, LLC v. Baldacci*, 505 F.3d 28 (1st Cir. 2007). Exact figures are not essential (no more than estimates may be possible) and the evidence need not be in the record if it is subject to judicial notice, but it takes more than lawyers' talk to condemn a statute under *Pike*.

According to the First Circuit, the plaintiffs met their initial burden because Section 19F subjected large wineries located outside Massachusetts to disproportionate burdens not imposed on small wineries located in Massachusetts. Myopically and out-of-context, that may be so. But looking at the history and function of both alcohol regulation and the Commerce Clause, it is difficult to understand how the First Circuit ever got beyond the maxim's first criterion, *i.e.* that those affected are "similarly situated entities."

Where's The Proof?

Much of the opinion in *Family Winemakers of California v. Jenkins* focuses on what is purported to be an economic analysis demonstrating the existence and impact of Section 19F's discriminatory affect on out-of-state wineries relative to in-state wineries. Massachusetts' argument that the law was not discriminatory because it did not grant any special privilege to Massachusetts' wineries was flatly rejected. According to the First Circuit "the wine market is a single although differentiated market, and § 19F's two provisions operate on that market together."

The specific evidence or "proof" for such a conclusion is not well referenced by the *Family Winemakers of California v. Jenkins* decision. The First Circuit's decision describes certain concepts regarding competitive channels of distribution and the relative benefits of access to several channels versus one specific channel. However, governing case law makes clear that proof of discriminatory effect should be clearly demonstrated by evidence, not lawyer's arguments, and that the plaintiff bears the burden of presenting that proof.

²⁷ *Pharmaceutical Research and Mfrs. of America v. Concannon*, 249 F.3d 66, 83-84 (1st Cir. 2001).

According to the First Circuit’s own precedents, the party claiming discrimination has the burden to put on evidence of a discriminatory effect on commerce that is “significantly probative, not merely colorable.”²⁸ That party must show “both how local economic actors are favored by the legislation, and how out-of-state-actors are burdened.”²⁹ Not every benefit or burden will suffice—only one that “alters the competitive balance between in-state and out-of-state firms.”³⁰

It is instructive to see how the presentation of evidence led to opposite results in two recent wine law cases, one of which was decided by the First Circuit and cited extensively by the appellate court in the *Family Winemakers of California v. Jenkins* decision. *Cherry Hill Vineyards v. Baldacci*³¹ and *Cherry Hill Vineyards, LLC v. Lilly*,³² both involved challenges to state laws regulating direct sales by wineries to consumers.

The Maine law challenged in *Baldacci* allowed a small “farm winery” to sell its products directly to consumers (bypassing the otherwise mandatory distribution chain through a licensed wholesaler and a licensed retailer) in face-to-face transactions on its premises and at up to two off-site locations established by the winery within Maine.³³ A farm-winery license was available on equal terms to Maine and out-of-state wineries. The out-of-state wineries claimed that the Maine statute discriminated against interstate commerce by preventing them from selling their wines directly to Maine consumers.³⁴

²⁸ *Alliance of Auto. Mfrs. v. Gwadosky*, 430 F.3d 30, 40 (1st Cir.2005) (internal quotation marks omitted).

²⁹ *Cherry Hill Vineyards, LLC v. Lilly*, 553 F.3d 423, 432 (6th Cir.2008) (internal quotation marks omitted). *See also Kleinsmith v. Shurtleff*, 571 F.3d 1033, 1040-41 (7th Cir. 2009) (Party claiming discrimination under dormant Commerce Clause has burden to put on evidence of discriminatory effect on commerce that is significantly probative, not merely colorable; challenger must show both how local economic actors are favored by legislation, and how out-of-state actors are burdened).

³⁰ *Cherry Hill Vineyard, LLC v. Baldacci*, 505 F.3d 28, 36 (1st Cir. 2007); *see West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 196 (1994) (a state law that “cause[s] local goods to constitute a larger share, and goods with an out-of-state source to constitute a smaller share, of the total sales in the market” is unconstitutional “because it, like a tariff, neutralizes advantages belonging to the place of origin.” (brackets and internal quotation marks omitted)); *R & M Oil & Supply, Inc. v. Saunders*, 307 F.3d 731, 734-35 (8th Cir.2002) (Illinois-based propane seller failed to present sufficient evidence that Missouri statute requiring sellers to have in-state propane-storage facility put it at competitive disadvantage); *see also Cloverland-Green Spring Dairies, Inc. v. Pa. Milk Mktg. Bd.*, 462 F.3d 249, 260-70 (3d Cir.2006) (out-of-state challenger failed to show that Pennsylvania milk-pricing scheme negated its competitive advantage); *cf. Granholm*, 544 U.S. at 473-74 (holding discriminatory a law that required out-of-state wine, but not in-state wine, to pass through an in-state wholesaler and retailer before reaching consumers, adding “two extra layers of overhead” and thus a “cost differential ... [that] can effectively bar small [out-of-state] wineries from the Michigan market.”).

³¹ 505 F.3d 28 (1st Cir. 2007).

³² 553 F.3d 423 (6th Cir. 2008).

³³ 505 F.3d at 30-31.

³⁴ *Id.* at 31-32.

The First Circuit rejected the challengers' claim under the dormant Commerce Clause because they had “proffered no evidence that permitting farm wineries to sell only face to face, either on premises or at approved in-state locations, discriminates against interstate commerce.”³⁵ They had not produced evidence that “Maine law acts to protect Maine vineyards or that Maine consumers substitute wines purchased directly from Maine vineyards for wines that they otherwise would have purchased from out-of-state producers”; that “any wines at all are purchased by consumers directly from Maine vineyards”; or that the law “somehow alters the competitive balance between in-state and out-of-state firms.” The First Circuit continued:

[P]laintiffs have adduced no evidence that would in any way undermine the plausible impression that Maine consumers (like imbibers everywhere) view trips to a winery as a distinct experience incommensurate with-and, therefore, unlikely to be replaced by-a trip to either a mailbox or a retail liquor store. Nor have they offered evidence to impeach the suggestion, made in one of the cases on which they rely, that bottles of wine are unique and, thus, unlikely to be perceived by consumers as interchangeable.³⁶

In *Lilly*, by contrast, the challengers (one of whom had also been a plaintiff in *Baldacci*) made an evidentiary showing of the discriminatory effect of Kentucky's law permitting licensed small wineries, whether in-state or out-of-state, to ship wine directly to consumers (thus bypassing wholesalers and retailers) but only if the consumer purchased the wine in person at the winery.³⁷ The evidence showed that in Oregon, the home of Cherry Hill Vineyards, only 13 of the 300 wineries marketed their wine in Kentucky, and most of the 300 were small.³⁸ Because it is not economical for a wholesaler to carry the products of a small winery, many were “foreclosed from the Kentucky market altogether unless they [could] take orders directly from Kentucky residents and ship wine.”³⁹ In particular, “Cherry Hills aver[red] that in order to distribute their wine through a wholesaler, they and other wineries pay up to 50% of their profits to the wholesaler, which can result in a profit differential of \$10-15 per bottle of wine.”⁴⁰

Moreover, some Kentucky residents stated that they “would buy wines directly from out-of-state wineries but for the in-purchase requirement.” Based on this record of testimony,

³⁵ *Id.* at 36.

³⁶ *Id.* at 37 (citation and footnote omitted).

³⁷ 553 F.3d at 427-28.

³⁸ *Id.* at 432.

³⁹ *Id.* at 433.

⁴⁰ *Id.*

the Sixth Circuit concluded that “Plaintiffs have presented specific evidence that meets the[ir] burden.... Plaintiffs have demonstrated that the challenged statutes discriminate against interstate commerce in practical effect.”⁴¹

Unlike the challengers in *Baldacci*, the challengers in *Lilly* presented evidence that could satisfy the plaintiff’s burden to establish a discriminatory effect of the state law under review. Did the Family Winemakers of California meet their evidentiary burden?

Presumably, the plaintiffs were speaking for the smaller “large” wineries when they argued that Section 19F impaired the competitiveness of these out-of-state wineries. Even if they had made a competent showing of those wineries’ economic loss attributable to the law (and based on the arguments reviewed above, that is not entirely clear), the plaintiffs still would need to show a discriminatory effect upon interstate commerce in the interstate wine market as a whole. That evidence likewise seems scant in the First Circuit’s opinion.

The U.S. Supreme Court’s precedent in *Exxon Corp. v. Governor of Maryland*⁴² is instructive. In that case, the Supreme Court considered a dormant Commerce Clause challenge to a Maryland statute that prohibited producers and refiners of petroleum products from operating retail service stations within the state. Among the challengers were out-of-state refiners who sold their gasoline in Maryland only through stations that they owned. The challengers pointed to evidence that the statute would cause them to discontinue selling in Maryland.⁴³ However, the Supreme Court was not persuaded because the fate of a single interstate business, or even a class of such businesses, was not dispositive. The Court said:

Some refiners may choose to withdraw entirely from the Maryland market, but there is no reason to assume that their share of the entire supply will not be promptly replaced by other interstate refiners. The source of the consumers’ supply may switch from company-operated stations to independent dealers, but interstate commerce is not subjected to an impermissible burden simply because an otherwise valid regulation causes some business to shift from one interstate supplier to another.⁴⁴

In language that seems applicable to the situation in Massachusetts, the Supreme Court in *Exxon* explained: “We cannot ... accept appellants’ underlying notion that the Commerce Clause protects the particular structure or methods of operation in a retail market.... [T]he

⁴¹ *Id.*

⁴² 437 U.S. 117 (1978).

⁴³ *Id.* at 127

⁴⁴ *Id.*

Clause protects the interstate market, not particular interstate firms, from prohibitive or burdensome regulations.”⁴⁵

In light of *Exxon*, Family Winemakers of California at least should have produced specific evidence that sales of conventional grape wines sold on the interstate market by small “large” producers outside of Massachusetts were in fact being usurped by Massachusetts small wineries selling farm wines. Perhaps they did; however, that evidence is missing from the First Circuit’s opinion.

Farm Wines & The “Interstate Wine Market.”

If the First Circuit’s fundamental conclusion that Massachusetts small farm wineries compete in the same market as large wineries were a given, this issue of sufficient evidence might be a non-issue. However, the possibility that the market for Massachusetts farm wines is different from the conventional “interstate wine market” deserves more consideration that was received in the pages of the *Family Winemakers of California v. Jenkins* opinion.

After all, a violation of the Commerce Clause requires discrimination that burdens interstate commerce by favoring local economic interests to the disadvantage of out-of-state competitors. Is that really what Section 19F did? To put the salient question more directly: Are “large” wineries that sell conventional wines in the “interstate wine market,” regardless of their location, really competing with small wineries that sell farm wines solely within their respective states?

At one point in its analysis, the First Circuit points to Section 19F’s focus on grape wine, and its exclusion of other fruit wines from the calculus of the 30,000 gallonage cap, as proof of the Massachusetts Legislature’s discriminatory intent. The appellate court cited legislative history revealing a state senator’s naked attempt to shield a local winery that also made orchard fruit wines from Section 19F’s gallonage cap. According to the appellate court:

The senator had another concern—that the winery in question, which primarily produced fruit wine, “comes close to the 30,000 [gallon] production limit” for “small” wineries and would likely soon exceed it because -11-“it’s a winery that is growing . . . and certainly uses wholesalers in other states.” The senator urged modifications to § 19F because “we should be promoting this kind of industry and not adopting regulations, however inadvertently, that might take away the advantage that the winery would have.” The draft of § 19F was amended shortly thereafter to exempt non-grape fruit wine production from the 30,000 gallon cap, and that version was enacted. (Footnote omitted).

From this evidence, the First Circuit then concluded that:

⁴⁵ *Id.* at 127-28. See *Brown & Williamson Tobacco Co. v. Pataki*, 320 F.3d 200, 212-13 (2d Cir.2003).

The fact that this gallonage cap excludes wines made from fruits other than grapes, no matter how many gallons a winery produces per year, is particularly probative. In past years, Massachusetts's largest winery produced more than 30,000 gallons of wine annually because between half and three-quarters of its production came from apple wines. The main effect of the fruit wine exception was to guarantee that this winery, like all other Massachusetts wineries, could take advantage of § 19F(b)'s beneficial distribution rules for "small" wineries. Massachusetts has offered no other explanation for the fruit wine exception, and there is no obvious reason why it would serve § 19F's ostensible purposes. This exception, like similar, facially neutral statutory exemptions apparently motivated by a desire to shield in-state interests, "weaken[s] the presumption in favor of the validity of the [general provision], because [it] undermine[s] the assumption that the State's own political processes will act as a check on local regulations that unduly burden interstate commerce." (Citation omitted).

While the legislative record is undeniable, the predicate for finding actionable discrimination under the Commerce Clause is less clear. Two flaws in the appellate court's reasoning merit consideration.

First: Is it true, either in terms of economics or common sense, that orchard fruit farm wines (e.g. apple wine, peach wine, blueberry wine, etc.) compete in the same product market as conventional wines sold across America? If economic analysis is the correct yardstick for measuring this issue, consider the contrasting data. 304 million cases of conventional grape wines were sold in the United States in 2007 (the year following Section 19F's enactment). Estimated dollar values for that conventional "market" exceed \$100 billion at the retail level.

On the other hand, the numbers for sales of other fruit wines such as those excluded from consideration by Section 19F amounted to . . . well, who knows? Both the quantity and dollar values for orchard fruit wines are so small relative to grape wine that the two "markets" seem arguably incomparable.

Likewise, the infrastructure for organizing orchard winemakers and marketing their products is equally stark. At the producer level, conventional grape winemakers are represented by trade associations such as the impressive and influential [Wine Institute](#). Orchard fruit wineries apparently have no comparable organization to promote sales or advocate on their behalf.

Similarly, at the retail level, chain package (and grocery stores, where allowed by state law) invariably devote significant shelf space to selling conventional grape wines. Few if any of these licensed off-premises retailers currently sell orchard fruit wines. The "market" for these farm wines is neither large, cohesive, established nor readily defined.

Given these material dissimilarities between large and small wine producers, it is reasonable to question a finding of commercial discriminatory effect on a premise that large conventional grape wine producers who sell in an interstate market and small farm wineries who appear to sell only to local consumers compete in the same economic market. Large and small wineries both may sell their respective products in Massachusetts, but it is unclear from the evidence referenced by the First Circuit that both groups compete for the same consumers in the same market.

Indeed, the First Circuit tacitly recognized the material distinction between large and small wineries, albeit for a very different purpose. In rebutting Massachusetts' argument that Section 19F did not discriminate against interstate commerce because 4713 wineries across the country qualified as small wineries under the law, the appellate court noted in footnote 12 of its opinion:

It is true, as Massachusetts argues, that in 2006, 4,713 wineries qualified as "small" under § 19F(b). But more than a third of these wineries produced less than a gallon of wine a year and cannot really be considered part of the interstate wine market. Moreover, many "small" out-of-state wineries likely distribute virtually all of their wine through in-person sales or to their home-state markets.

This begs a simple but pertinent question: if small out-of-state wineries can be dismissed from the interstate commerce analysis because they really do not participate in the interstate wine market, why does the same not hold true for Massachusetts' small wineries? Did the plaintiffs present any evidence that Massachusetts wines are sold anywhere other than Massachusetts? Such evidence may have been presented, but it is not referenced in the First Circuit's opinion, and that's important. If the plaintiffs did not present evidence that local Massachusetts farm wines compete in the same product market as the conventional "interstate wine market," then where is the impermissible burden imposed by Section 19F?

Likewise, did the litigants address evidence that small wineries outside Massachusetts did, in fact, seek a direct shipping license under Section 19F to sell their products in the commonwealth. The First Circuit's decision acknowledges that "Twenty-seven of Massachusetts's thirty-one wineries have obtained "small" winery licenses; in contrast, only twenty-six of the 2,933 out-of-state "small" wineries producing more than a gallon per year have done so." Using the type of economic analysis favored throughout the rest of the First Circuit's opinion, though, raises this unanswered question: ***Doesn't the arrival of 26 new "small" winery competitors from outside Massachusetts, selling alongside the 31 existing Massachusetts small wineries, demonstrate that Section 19F in fact promotes, rather than impedes, interstate competition?***

Similarly, if Massachusetts ever is fortunate enough to have a winery that does produce more than 30,000 gallons of grape wine so that it can effectively compete in the interstate wine market, where is the evidence to suggest that it would still enjoy protection under Section 19F? The language of the law makes clear that any winery breaching the

gallonage cap, no matter where it exists, must be deemed a “large” winery and governed accordingly.

Second: Given the quantifiable differences between the mature and successful interstate grape wine market versus the relatively undeveloped and decidedly parochial grape and orchard fruit farm wine market, why can’t a state harmonize its dual interests in alcohol regulation and agricultural support by crafting a facially neutral law that fosters small farmers and farm wines while pushing the vast majority of the interstate wine market’s products (i.e. conventional grape wines) through the traditional three-tier system? Critics of this concept might point to the inconsistencies of “alcohol regulation” that exempts orchard fruit wines which possess the same alcohol levels as grape wines. The point is accurate, but misplaced.

If alcohol regulation alone were the absolute lodestar of the analysis, then no direct shipping of any kind would be tolerated. “Temperance” would dictate that all alcohol products flow through the “unquestionably legitimate” three-tier system, and *Granholm v. Heald* never would have come to court. However, we do not live in a world of absolutes.

States’ Rights and Deference in the Balancing of Interests.

State laws that are location-neutral on their face regularly pass the *Pike* balancing test,⁴⁶ because the U.S. Supreme Court has made clear that it is wary of second guessing legislatures under the aegis of the Commerce Clause.⁴⁷ Indeed, the First Circuit recognized that when it rejected a Commerce Clause challenge by interstate retailers to Rhode Island’s restrictions on the ability of chain and franchise stores to sell alcohol beverages at retail:

⁴⁶ See, e.g. *Department of Revenue of Kentucky v. Davis*, 128 S. Ct. 1801, 1808–09 (U.S. 2008); *Pharmaceutical Research and Mfrs. of America v. Concannon*, 249 F.3d 66 (1st Cir. 2001) (Maine statute creating program which allows enrollees to purchase prescription drugs from participating Maine pharmacies at a discounted price, with the discount reimbursed by the state with the money raised from “rebate payments” collected from participating drug manufacturers, and under which a drug manufactured by a nonparticipating manufacturer may not be dispensed to a Medicaid beneficiary without the approval of the State Medicaid administrator, is not facially invalid under the dormant Commerce Clause, applying the *Pike* balancing test; when measuring manufacturers’ possible loss of profits against the increased access to prescription drugs for Maine citizens, the burden on interstate commerce is not clearly excessive as compared to the local benefits.).

⁴⁷ For recent cases holding that *Pike* tolerates state laws of dubious benefit, see, e.g. *Wine and Spirits Retailers, Inc. v. Rhode Island*, 481 F.3d 1, 15-16 (1st Cir. 2007) (upholding Rhode Island’s restrictions on the ability of chain and franchise retailers to sell alcohol beverages); *Doran v. Massachusetts Turnpike Authority*, 348 F.3d 315, 322 (1st Cir. 2003) (Massachusetts toll booth program giving discounts to program subscribers but not to subscribers of comparable services offered in other states, did not violate dormant Commerce Clause where commonwealth had legitimate local interest in collecting tolls on facially neutral basis for public highway maintenance); see also *Cavel International, Inc. v. Madigan*, 500 F.3d 551 (7th Cir. 2007); *National Paint & Coatings Ass’n v. Chicago*, 45 F.3d 1124 (7th Cir. 1995).

The plaintiffs' argument that consumers would be advantaged by unregulated competition in retail liquor sales, like the argument rejected in *Exxon*, "relates to the wisdom of the statute, not to its burden on commerce." *Id.* at 128, 98 S.Ct. 2207. It is, therefore, of little moment. The bottom line is that the plaintiffs have failed to prove a violation of the dormant commerce clause.⁴⁸

Nevertheless, the First Circuit in *Family Winemakers of California v. Jenkins* refused to engage in such deference. Why?

In its opinion, the appellate court repeatedly noted that Massachusetts had failed to explain the relevance of its restrictions on direct shipping in today's market place, and why less restrictive means could not have achieved the government's stated regulatory objectives. What is unclear from the opinion is why nobody seems to have argued what surely was (or should have been) the core objective of state alcohol regulators, *i.e.* allowing small farm wineries to access the Massachusetts market with products that otherwise likely would be unmarketable, while simultaneously preserving a regulatory system that continues to push the largest majority of conventional alcohol in the interstate marketplace through the traditional three-tier system of oversight. That seems to be the 800 pound elephant in the room that nobody wants to discuss.

Critics of the gallonage caps argue that nobody will discuss this hybrid objective because it concedes that the law discriminates against large wineries. Maybe, but so what?

Does size matter? The Commerce Clause does not protect large against small; it protects out-of-state competitors against discriminations intended to unfairly protect local economic interests. Nothing in the Constitution states that large industry members have the right to compete on even terms with small industry members where their products and markets are distinguishable.

Indeed, a careful review of the history of alcohol regulation in America following the repeal of Prohibition, at both the state and federal levels, demonstrates numerous and repeated efforts built into the system for the specific purpose of protecting the smaller "Mom & Pops" of the alcohol industry against larger competitors and industry members. Trade practices that shelter smaller retailers, tax rates that are lower for smaller producers, mandatory non-discrimination laws mandating the sale of products to all licensees at the same price, regardless of the retailer's size or purchasing capacity – these and similarly protective laws demonstrate a 75 year pattern and practice of regulating alcohol in a way that legally and legitimately assures effective oversight while recognizing the public interest in preserving the viability of smaller industry members.

If this concept was argued effectively to either the District Court⁴⁹ or the First Circuit, the judges clearly missed the point. Instead, both courts tracked the legislative history of

⁴⁸ *Wine and Spirits Retailers, Inc. v. Rhode Island*, 481 F.3d 1, 15-16 (1st Cir. 2007).

⁴⁹ In the District Court's ruling, U.S. District Judge Zobel dismissed the legitimate purpose of the state's regulation: "In any event, even if § 19F were not discriminatory in purpose or effect, it would still fail the

Section 19F as reflecting nothing but a segue from one discrimination (local vs. out-of-state) to another (large vs. small):

Before 2005, § 19B, Massachusetts's farmer-winery licensing law, on its face allowed only in-state wineries to obtain licenses to combine distribution methods through wholesalers, retailers, and direct shipping to consumers. Mass. Gen. Laws ch. 138, § 19B (2002). Five months after Granholm invalidated similar facially discriminatory state laws, §19B was held to be invalid under the Commerce Clause. *Stonington Vineyards v. Jenkins*, No. 05-10982-JLT, slip op. at 1-2 (D. Mass. Oct. 5, 2005). In 2006, the Massachusetts legislature enacted § 19F over then-Governor Romney's veto. Section 19F does not distinguish on its face between in-state and out-of-state wineries' eligibility for direct shipping licenses, but instead distinguishes between "small" or "large" wineries through the 30,000 gallon cap.

The appellate court's decision made skeptical reference to the notion that the government had a very real and certainly legitimate interest in striking a reasonable balance between protecting smaller industry members while continuing to assure that the vast majority of alcohol continues to pass through the "unquestionably legitimate" three-tier system. Indeed, when recapping the arguments advanced by Massachusetts to support the intended purposes of Section 19F, the First Circuit could not resist linking the legitimate with the illegitimate:

The gap between Massachusetts's professed neutrality and § 19F's practical effects also underscores the conclusion of discriminatory purpose. See Hunt, 432 U.S. at 352 (observing that the disparity between a law's asserted ends and its means was "somewhat suspect" and evidenced a likely discriminatory purpose). Massachusetts has asserted various purposes behind § 19F: to facilitate direct shipment, to further the three-tier system, to make all small wineries, irrespective of their location, better able to compete, and to thereby provide Massachusetts consumers with greater choice. The 30,000 gallon cap

Pike test, under which a statute is upheld only if its burden on interstate commerce is not "clearly excessive in relation to the putative local benefits." *Pike*, 397 U.S. at 142.19 "If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend upon the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities." *Id.* Under § 19F, "large" wineries are permitted, as a practical matter, to sell only to wholesalers, with the resultant unnecessary burdens on interstate commerce, as discussed *supra*. **However, there are no putative local benefits served by § 19F's two-tier system. Moreover, even if one accepts the Commonwealth's assertion that the purpose of § 19F is to allow "small" wineries nationwide to direct ship because of the difficulties they face in retaining wholesaler representation, this goal would not be undercut by allowing "large" wineries the same privileges.** (Emphasis added). What the District Judge failed to grasp was the local benefit gained not by local producers, but by local consumers, in assuring that the bulk of the wine sold and consumed in Massachusetts passed through the unquestionably legitimate three-tier system. Effective alcohol regulation, not market economics, is the point inadequately addressed by both the District Court and the First Circuit.

and the fruit wine exception, Massachusetts claimed at oral argument, reflected the legislature's rational assessment of the kind of wineries that needed special assistance because they were suffering from the limitations of the three-tier system. But these general aims stand in stark contrast to § 19F's specific and highly irregular features.

After running through its analysis of why the appellate judges determined that Section 19F was discriminatory in purpose and effect, the First Circuit turned to whether the law could nonetheless be saved as a proper exercise of state regulatory authority under the 21st Amendment. According to the appellate court, the state bore the burden of demonstrating by “concrete record evidence” that the challenged regulation was necessary to achieve asserted legitimate objectives.

Massachusetts apparently failed to prepare a record with any such evidence, or even submit any written legal arguments on the issue of what legitimate objectives justified Section 19F. According to the First Circuit:

The state did not brief this point. It was only in response to questioning at oral argument that Massachusetts characterized § 19F as the only feasible means the state has to serve the local purposes of benefitting small wineries, supporting the three-tier system, and increasing consumer choice. This argument is untimely and likely waived. It is also not supported by anything in the record. Several amici try to fill the gap, but amici may not make up for waiver by a party. See *United States v. Sturm, Ruger & Co., Inc.*, 84 F.3d 1, 6 (1st Cir. 1996).

Absent from the First Circuit's decision was the lack of respect for state discretion, as well as the lack of respect for relevant precedent from other federal courts that specifically have adjudicated the constitutionality of wine gallonage caps in state direct shipping laws.

With regard to state discretion, the 21st Amendment and alcohol's unique nature at least should afford state regulators some state power to define standards such as “large winery” and “small winery” without having to bow down to differing federal or industry standards. Yet, in *Family Wineries of California v. Jenkins*, the First Circuit seemed to dismiss such a concept. After acknowledging that states have some level of independence in this area, the appellate court immediately rejected the Massachusetts standards found in Section 19F because they failed to jibe with federal and industry definitions:

The wine industry and federal law have developed definitions of "small," "medium," and "large" wineries in order to describe the way the industry produces and distributes wines and, in the case of federal law, to offer "small" wineries regulatory benefits. These definitions do not, of course, bind states to particular regulatory choices. But their lack of correlation to § 19F belies Massachusetts's claim that § 19F's features reflected an objective choice to remedy the purported competitive disadvantage

faced uniquely by wineries producing 30,000 gallons or less of grape wine.

There seemed to be no dispute that large wineries competing in the interstate wine market account for the vast majority of the wine sold in America today. As the First Circuit noted in its decision:

Almost all of the country's wine production and sales come from a small number of wineries. In 2006, the five largest wineries in the U.S. produced approximately 70 percent of the country's wine. The country's thirty largest wineries comprised approximately 92 percent of the market, and each produced between 680,000 and 150 million gallons per year.

The appellate court also noted that together, the “large wineries that produce more than 30,000 gallons of grape wine account for ninety-eight percent (98%) of all wines sold in America.”

But do those facts alone tell the whole story? The Family Wineries of America argued, and the First Circuit accepted, the concept that Massachusetts’ gallonage cap was discriminatory in impact because there are no large wineries in Massachusetts. While true, that fact out of context is misleading to an accurate assessment of the law’s constitutionality. As noted above, only five wineries out of all the wineries in the entire United States of America account for approximately 70 percent of all the wine sold in this country. Only 30 wineries account for over 92 percent of that wine.

Here’s the rub: Even if every state had one of those Top Thirty wineries within its borders, there still would be 20 states without such a winery. Would that mean that those unlucky 20 states without a “big winery” are precluded from passing a law similar to Section 19F that seeks to allow smaller producers to compete effectively within their state’s markets while still assuring that over 98 percent of the wine flowing through the state passes through the protective oversight of the “unquestionably legitimate” three-tier system?⁵⁰

Supporters of the recent decision by the First Circuit might argue that Massachusetts got it wrong by drawing the gallonage cap too low. They, like the First Circuit, might embrace the data suggesting that 537 “large wineries” fall below the largest 100 wineries

⁵⁰ The First Circuit also emphasizes that the real discriminatory impact of Section 19F falls on those 607 “large” wineries who produce more than 30,000 gallons per year but less than 680,000 gallons, and which account for six percent (6%) of the nation’s wine production market. While 607 is significantly larger than 30, the First Circuit’s decision makes no reference to any evidence regarding what market activity these wineries have in Massachusetts. Nor does the opinion reference any evidence to show from what states these wineries operate (other than to note they are not based in Massachusetts). If most are based in California, Washington, Oregon and New York, the same question is begged: *Would that mean that those unlucky 46 states without a small “large” winery are precluded from passing a law similar to Section 19F that seeks to allow truly smaller producers to compete effectively within their state’s markets while still assuring that over 90 percent of the wine flowing through the state passes through the protective oversight of the “unquestionably legitimate” three-tier system?*

in America that produce over 90 percent of the nation's wines, but are forced to make the same Devil's choice for selling their products in Massachusetts – *i.e.* opting either for wholesaler distribution only, or direct sales to consumers only.

It is unclear, however, that the Commerce Clause really protects those 537 large wineries and their nationally-marketed conventional grape wines. As noted above, the interstate wine market arguably is not the same market as the farm wine market that Massachusetts farm wineries inhabit. Certainly, no member winery of the Family Winemakers of California sells only to Massachusetts residents; yet, did the plaintiffs produce any evidence in their litigation that Massachusetts-produced farm wines are sold anywhere other than in Massachusetts?

Likewise, where is the harm to interstate commerce by a law that extends distribution privileges to thousands of small wineries across the United States on an equal footing with the 31 small wineries located in Massachusetts? The First Circuit's decision does not reflect any argument on this point, but it does reference evidence that 26 out-of-state small wineries availed themselves of the opportunity presented by Section 19. Wouldn't this datum alone suggest that competition among small wineries in Massachusetts increased? After all, 31 in-state small wineries and 26 out-of-state small wineries means Section 19F effectively grew the number of licensed out-of-state small wineries to 46 percent of all the licensed small wineries doing business in the commonwealth.

Perhaps most significantly, where is the deference for the government's reasonable effort to achieve legitimate public purposes? That lack of deference, no doubt resulting from the unappealing record of Section 19F's legislative history, makes *Family Winemakers of California v. Jenkins* especially noteworthy.

The balance between the Commerce Clause and the 21st Amendment has undergone a great deal of scrutiny since the onslaught of the "Direct Shipping" lawsuits starting in the early 1990s. What seems to be missing from the First Circuit's ruling is an appreciation for the unique nature of alcohol regulation, and an understanding that Commerce Clause discrimination is predicated on assuring that inappropriate parochial interests do not create an undue burden on interstate commerce. Note the emphasis on these adjectives: "unique," "inappropriate" and "undue."

As is clear from over two-hundred years of jurisprudence, alcohol is a very unique consumer commodity, and it is recognized as such under the law. While local economic protectionism is anathema to an open market and a level playing field, alcohol is so different that states and communities possess the recognized right to completely prohibit the production and sale of the product within their respective jurisdictions. With this predicate in mind, it is fair to question how Section 19F is unconstitutionally discriminatory when it treats the 4,713 small wineries located in Massachusetts and across the rest of the United States equally.

That states have balanced the public's need for alcohol regulation against the public's desire to promote small farm wineries does not render the former invalid. It is axiomatic

that a legal system need not be 100% effective or foolproof in order to provide public benefit and be sustainable as a legitimate expression of legislative will. As the Seventh Circuit noted in *Baude v. Heath* when addressing arguments that the Indiana law requiring face-to-face wine sales for direct shipping purposes was not a foolproof method of preventing alcohol sales to minors:

As we observed in *National Paint*, a legal system need not be foolproof in order to have benefits. The face-to-face requirement makes it harder for minors to get wine. Anything that raises the cost of an activity will diminish the quantity – not to zero, but no law is or need be fully effective.⁵¹

In its decision, the First Circuit argued that Section 19F was unconstitutional because the state had a less restrictive option to achieve what the court construed as the purposes of the law, i.e. helping small wineries level the playing field. According to the appellate judges:

The record shows that at least one viable nondiscriminatory alternative existed when § 19F was under consideration: the Model Direct Shipment Bill, which the National Conference of State Legislatures adopted in 1997. The Model Bill does not define "small" or "large" wineries or regulate access to licenses depending on winery size. As an alternative to § 19F, then-Governor Romney proposed a version of the Model Bill which would have allowed all wineries to ship directly to consumers, sell to retailers, and distribute through wholesalers. But the state legislature rejected this proposal and overrode his veto. Plaintiffs argue that this alternative would have helped small wineries without undercutting the three-tier system because it included limitations on the total volume wineries could ship to consumers. Whatever the merits of this proposal, Massachusetts has never claimed it would be unworkable. Under similar circumstances, the Supreme Court has, as a rule, struck down the discriminatory state law in question. (Citations omitted).

Conspicuously absent from the court's analysis is Massachusetts' view of whether the "[Model Direct Shipment Bill](#)" in fact allows the state to achieve its legitimate objectives.

Had that argument been submitted by the defendant, the appellate court would/should have heard that the Model Direct Shipment in fact eviscerates the three-tier system. Yes, it contains "limitations on the total volume wineries could ship to consumers" as noted by the appellate court. However, those generous limitations amount to allowing each winery to sell and ship 24 cases of wine per year per person. It is doubtful that any resident of Massachusetts or anywhere else drinks two cases of the same wine per month, which averages out to almost a bottle a day.

⁵¹ *Baude v. Heath*, 538 F.3d 608, 614 (7th Cir. 2008).

In reality, the Model Direct Shipping Bill does nothing to ensure that the vast majority of alcohol furnished to Massachusetts residents is secured by processing through the three-tier system. Unfortunately, these concerns are not addressed by the First Circuit.

Creating A Conflict Among Courts:

What of the other federal courts that have upheld the 30,000 gallonage cap in Arizona and Kentucky, respectively? The First Circuit acknowledged those cases in a lowly footnote, dismissing them as unpersuasive without explanation:

n. 14 Nor do we find the reasoning of the two district court cases that have upheld other states' gallonage caps to be persuasive. See Black Star Farms, LLC v. Oliver, 544 F. Supp. 2d 913 (D. Ariz. 2008); Cherry Hill Vineyards, LLC v. Hudgins, 488 F. Supp. 2d 601 (W.D. Ky. 2006).

Beyond this simple footnote lies a greater conflict of jurisprudence.

Four states have imposed limits on the number of gallons that wineries can produce annually to be eligible to direct ship wines to consumers in their respective states. Gallonage limits, also known as “capacity caps,” have been adopted to define the population of wineries eligible to engage in direct shipping and sales in the following states:

1. Arizona 20,000 gallons;⁵²
2. Kentucky 50,000 gallons;⁵³
3. Massachusetts 30,000 gallons;⁵⁴ and
4. Ohio 250,000 gallons.⁵⁵

Lawsuits were filed to challenge the constitutionality of these gallonage limits in Kentucky and Arizona, as well as Massachusetts. The gallonage limits in Arizona and Kentucky have been held to be constitutional by federal courts in each of those states.

In *Cherry Hill Vineyards LLC v. Hudgins*,⁵⁶ the out-of-state winery that challenged that Kentucky’s 50,000 gallon production limit argued that the limit was protective of local industry and discriminated against out-of-state wineries because all of the in-state wineries annually produced less than the stated gallonage limit. The federal court held that Kentucky’s gallonage limit did not discriminate against out-of-state state producers and did not violate *Granholm v. Heald* because the law provides similar licensing

⁵² Sections 4-203.04 and 4-205.04, Ariz. Rev. Stat.

⁵³ Ky. Rev. Stat., s. 243.155.

⁵⁴ Mass. Gen Laws, ch. 138, s. 19F.

⁵⁵ Ohio Rev. Code, s. 4303.232.

⁵⁶ 488 F.S. Supp.2d 601 (W.D. Ky. 2006).

opportunities to in-state and out-of-state wineries. Because the law was facially neutral, the court stated that the restriction on direct sales and shipping does not give Kentucky wineries a competitive advantage over similarly situated out-of-state wineries.

In the Arizona case, *Black Star Farms, L.L.C. v. Oliver*,⁵⁷ an out-of-state winery also argued that the state's 20,000 gallon production limit discriminated against out-of-state wineries. The federal court in that case rejected the plaintiff's argument and held that the limit was facially neutral. The court noted that, as of 2004, more than half of the 2000 wineries in the United States were able to qualify under the Arizona gallonage cap. It noted that the number of wineries producing less than 20,000 gallons of wine a year "dwarfed the number of in-state wineries" that were able to qualify for Arizona's direct shipment license. The *Black Star Farms, L.L.C.* court also stated that "*the simple fact that there are more out-of-state wineries than in-state wineries that produce more than 20,000 gallons of wine per year and are thus required to adhere to the three-tiered distribution system in order to gain access to Arizona's wine market does not by itself establish patent discrimination in effect against interstate commerce.*"⁵⁸

The District Court that initially decided *Family Winemakers of California v. Jenkins* did not address either the *Cherry Hill Vineyards LLC v. Hudgins* or the *Black Star Farms L.L.C. v. Oliver* federal court decisions. The First Circuit in contrast expressly acknowledged both decisions, but dismissed them summarily and without explanation.

A New Construction for The 21st Amendment:

According to the First Circuit:

Whether the Twenty-first Amendment granted states the authority to enact even facially neutral but discriminatory alcohol laws that would otherwise violate the Commerce Clause was not decided by Granholm and the answer is not readily apparent from the text of the Amendment. Granholm holds the interpretation of this amendment instead turns on historical context. Section 2 of the Twenty-first Amendment granted the states the authority to regulate liquor only to the extent that they had done so before Prohibition under two federal laws: the Wilson Act of 1890²⁴ and the Webb-Kenyon Act of 1913.²⁵ See Granholm, 544 U.S. at 484.

The Supreme Court held in Granholm that through these Acts, ***Congress gave the states newfound powers to regulate alcohol that came within their borders, even if it had traveled in interstate commerce.*** The Wilson Act did this by allowing states to restrict or prohibit the sale of out-of-state alcohol "to the same extent and in the

⁵⁷ 544 F.Supp.2d 913 (D. Ariz. 2008).

⁵⁸ *Id.* at 925-926.

same manner" as alcohol that was produced in-state. 544 U.S. at 478 (quoting 27 U.S.C. § 121) (internal quotation marks omitted). The Webb-Kenyon Act expanded states' regulatory authority by expressly authorizing states to regulate alcohol that traveled in interstate commerce even if it was being shipped solely for consumers' personal use. *Id.* at 481-84. These Acts did not, however, exempt states from the Commerce Clause's existing prohibitions on state laws that discriminated against out-of-state goods and favored local interests. *Id.* at 484-85.

The precise question in Granholm was what effect, if any, the Twenty-first Amendment has upon facially discriminatory state alcohol laws that would otherwise be subject to invalidation under the Commerce Clause. 544 U.S. at 471. The question of whether the Twenty-first Amendment protects facially neutral laws like § 19F was not before the Court. (Emphasis added; citations omitted).

From this starting point, the First Circuit began its stab at making jurisprudential history. According to the appellate court, *Family Wineries of California v. Jenkins* required an exploration of legal territory beyond *Granholm* because the law in question was not facially discriminatory.

Section 19F was discriminatory in purpose (remember those parochial Massachusetts legislators) and effect (recall those 537 out-of-state wineries referenced by the appellate court that were so large that they exceeded the 30,000 gallonage cap, but not big enough to go unhurt by having to pick between direct shipping or wholesale distributing of their wines). Once that discrimination was established, nothing presented in the record could save the law from unconstitutionality.

Had Section 19F had less dubious origins, if the First Circuit had focused more on the true nature of the economic markets in question, and if Massachusetts had laid greater emphasis on the legitimate public purposes served by Section 19F, the appellate court might have offered a different assessment of gallonage caps as a tool for effective alcohol regulation.

Why Legitimately Crafted Gallonage Caps Are Legal:

Gallonage limitations were not at issue in *Granholm*. Since then, several courts have directly addressed the constitutionality of these caps, and upheld them. However, the First Circuit gave these decisions only passing acknowledgment in *Family Winemakers of California v. Jenkins*. In its footnote 14, the First Circuit's decision states rather dismissively:

Nor do we find the reasoning of the two district court cases that have upheld other states' gallonage caps to be persuasive. See *Black Star*

Farms, LLC v. Oliver, 544 F. Supp. 2d 913 (D. Ariz. 2008); Cherry Hill Vineyards, LLC v. Hudgins, 488 F.Supp. 2d 601 (W.D. Ky. 2006).

Both cases, however, warrant closer examination.

Cherry Hill Vineyards v. Hudgins. On December 26, 2006, the federal district court in *Cherry Hill Vineyards v. Hudgins* upheld a licensing provision under the Kentucky statutes which permitted both in-state and out-of-state "small farm wineries" to apply for a small farm winery license. The statute defined "small farm winery" as one producing wines not exceeding 50,000 gallons per year.⁵⁹ The plaintiffs challenged the statute because its 50,000 gallon limit afforded a license to all Kentucky wineries (because none produced more than 50,000 gallons per year) but excluded many out-of-state wineries with no apparent purpose.

The *Cherry Hill* court noted that there was no facial discrimination against out-of-state wineries, as the 50,000 gallon limit applied equally to in-state and out-of-state wineries. Moreover, the Court found that the limit did not run afoul of *Granholm* because there was no showing that the limit burdened out-of-state producers or shippers simply to give a competitive edge to in-state businesses. The Court found that Kentucky did not need to justify the amount of the limit, because it gave no competitive advantage to similarly-situated (i.e. 50,000 gallons or less) producers.

Black Star Farms, LLC v. Oliver. On February 26, 2008, the U.S. District Court in Arizona upheld the state's 20,000 gallon annual production cap exception for direct shipping. The court also upheld Arizona's in-person transaction exception, allowing all wineries—in-state or out—to directly ship two cases of wine per year to Arizona residents so long as the consumer was physically present at the winery when the purchase occurred, finding that neither law violated the Commerce Clause or otherwise was

⁵⁹ Other states that have passed gallonage limitations have generally done so in amounts lower than 50,000. Massachusetts, of course, permitted in-state and out-of-state wineries with total annual production less than 30,000 gallons to obtain a "small winery shipment license" that authorizes them to sell and ship wine "at retail directly to consumers" and at wholesale in certain circumstances. Mass. Gen. Laws ch. 138, § 19F(b). Arizona permits in-state and out-of-state wineries with total annual production less than 20,000 gallons to make sales and deliveries of wine to retailers and "to consumers off of the licensed premises and that is ordered by telephone, mail, fax or catalogue, through the internet or by other means." A.R.S. § 4-205.04(C)(7) & (9). In-state and out-of-state wineries with total annual production greater than 20,000 gallons cannot ship wine directly to retailers and consumers (although they apparently can take orders from Arizona residents via the Internet, mail order and telephone, and then deliver the wine through Arizona's three-tier system, i.e., deliver the wine to a licensed Arizona wholesaler, who then delivers it to a licensed Arizona retailer, who delivers it to the consumer). A.R.S. § 4-203.04(E), (G) & (H). The same is true for Ohio, which uses a gallonage cap of 250,000 to qualify wineries for direct shipping privileges. §4301.10(A)(8)(c), Ohio Rev. Code.

Gallonage caps have not invariably been challenged. Maine, for example, does not allow either in-state or out-of-state wineries to ship wine directly to its residents, but permits in-state and out-of-state wineries to obtain a license that allows them to sell wine on premises located in Maine. 28-A M.R.S.A. § 1355(3). The necessary license to conduct on-premises sales, however, is only available to wineries that produce wine "in an amount not to exceed 50,000 gallons a year." 28-A M.R.S.A. § 1355(3)(A).

unconstitutional. In *Black Star Farms v. Oliver*, the federal judge issued an order stating:

Plaintiffs essentially argue[d] that a state has only two options, either to apply the three-tiered distribution system to all wineries, or to completely abolish the three-tiered distribution system. However, those results are not dictated by *Granholm* and the anti-discrimination norm of the Dormant Commerce Clause.

The court determined that both the 20,000 gallon production cap and the face-to-face transaction exceptions were facially neutral, and that the plaintiffs had failed to show that Arizona's statutory scheme for regulating alcohol generally and wine in particular was discriminatory in effect. In its opinion, the court stated that "*Granholm* is not the panacea that plaintiffs make it out to be; and apart from topical similarity, its practical import to the instant case is limited."

The Arizona-based federal court distinguished *Granholm* by reasoning that the U.S. Supreme Court invalidated discriminatory beverage laws from two states that allowed all in-state, but no out-of-state, wineries to bypass the existing three-tiered distribution system and ship wine directly to in-state consumers. In contrast to the laws of Michigan and New York, Arizona's statutes in question apply equally to both in-state and out-of-state wineries. According to the federal court: "Three-tiered systems such as this are considered 'unquestionably legitimate;' a constitutional exercise of State power under the Twenty-First Amendment for the purpose of controlling the distribution of alcoholic beverages, promoting temperance, and facilitating means of collecting excise taxes."

In addition to the two decisions referenced by the First Circuit, a third federal court has issued a decision that contains analysis favorable to gallonage caps, although it did not address the issue directly. In *Action Wholesale Liquors v. Oklahoma*,⁶⁰ the court held that Oklahoma's direct shipping law (which did not contain a gallonage cap) violated *Granholm* because it permitted Oklahoma wineries, but not out-of-state wineries, to sell and ship wine directly to in-state retailers. In addressing potential legislative revisions, the federal court said:

Nothing in *Granholm* removes small wineries from favorable - even discriminatory - legislative consideration, as long as in-state and out-of-state small wineries receive essentially identical legislative treatment. Legislative discrimination on the basis of the size of commercial enterprises (i.e., more favorable treatment for small wineries, in-state or out-of-state) does not implicate interests that have enjoyed exacting judicial review. . . . The court's decision today should not, therefore, be understood to cast doubt upon the authority of the State of Oklahoma to enact

⁶⁰ No. CIV-06-0239-F, 2006 WL 3324732 (W.D. Okla. Nov. 15, 2006).

provisions which nurture Oklahoma's nascent small winery enterprises, as long as the classification applies substantially equally to small wineries both within and outside of Oklahoma.⁶¹

Even-handed gallonage cap laws are precisely the sort of legislation that the Oklahoma court opined would raise no constitutional issue: they create classifications based on the size of wineries that apply equally to in-state and out-of-state wineries.

So, where's the problem? On first examination, gallonage caps that apply equally to in-state and out-of-state wineries arguably do not implicate the dormant Commerce Clause or *Granholm* at all. The dormant Commerce Clause is concerned solely with discrimination against interstate commerce, such as distinctions between in-state and out-of-state businesses, and does not speak to other types of legislative classifications among businesses. Accordingly, so long as gallonage caps are facially neutral and apply even-handedly to in-state and out-of-state wineries - as the Arizona and Kentucky caps do - they arguably raise no issue under the dormant Commerce Clause or *Granholm*. Of course, gallonage caps that draw distinctions between in-state and out-of-state wineries (for example, by permitting only in-state wineries below a cap to ship directly, or by applying different gallonage caps to in-state and out-of-state wineries) could raise issues under the dormant Commerce Clause.

Nor do the gallonage caps raise any colorable issue under the Equal Protection Clause, although the First Circuit in *Family Winemakers of California v. Jenkins* suggests in its footnote 15 that such a challenge might have been successful against Massachusetts. The Equal Protection Clause is concerned with all manner of legislative classifications and the unequal treatment that they might complain of is due to an express legislative classification (based on the size or production volume of the wineries).

It is not surprising that none of the plaintiffs in the gallonage cap lawsuits has pursued an Equal Protection Clause claim. Legislative classifications that do not involve a suspect class (such as race or gender) or a fundamental right (such as voting) are only subject to very limited judicial scrutiny to determine whether they have a rational basis,⁶² and the gallonage caps easily would survive such review.

Although the First Circuit repeatedly criticized Massachusetts for failing to adequately do so, states generally can overcome Equal Protection claims against gallonage caps by proffering any number of rational public policy justifications for allowing smaller but not larger wineries to ship directly, such as the determination that small, but not large, wineries often have difficulty finding in-state wholesalers to distribute their wine. Indeed, the First Circuit expressly recognized this issue in the context of determining that Massachusetts' 30,000 gallonage cap defined as "large" wineries over 600 out-of-state producers who -- in the view of the appellate court -- deserved to be classified as small

⁶¹ *Id.* at 11 n.8 (emphasis in original).

⁶² *See, e.g. Williamson v. Lee Optical Co.*, 348 U.S. 483 (1955).

wineries because they too had problems securing wholesale distribution in Massachusetts.

States also could rebut an Equal Protection claim and justify the differential treatment of large and small wineries based on a desire to promote tourism by facilitating the development of small, local wineries and wine-producing regions, or to preserve their wine making heritage.⁶³ The current jurisprudence on Equal Protection law is such that state law classifications based on the size of business entities routinely are upheld under the Equal Protection Clause.⁶⁴

Equal Protection, however, is not the greater legal challenge facing state legislators and regulators. As the First Circuit just demonstrated, the dormant Commerce Clause is where the action is.

The Family Winemakers of California claimed that the facial even-handedness of Massachusetts' Section 19F was just a pretext, and that the gallonage caps in fact had both "a discriminatory purpose and a discriminatory effect."⁶⁵ But do the claims of "discriminatory effect" really hold up?

As noted previously, in *Granholm*, the U.S. Supreme Court held that state laws have a discriminatory effect if they "burden out-of-state producers or shippers simply to give a competitive advantage to in-state businesses." The even-handed gallonage caps do not mandate any differential treatment of in-state and out-of-state wineries. To the contrary, the gallonage caps accord identical treatment to out-of-state wineries and their in-state

⁶³ See, e.g. *Fitzgerald v. Racing Association of Central Iowa*, 539 U.S. 103, 109 (2003) (rejecting equal protection challenge to Iowa law that imposed lower tax on riverboat slot machines than on racetrack slot machines because the State rationally "may have wanted to encourage the economic development or river communities or to promote river boat history").

⁶⁴ See, e.g., *Fox v. Standard Oil Co. of New Jersey*, 294 U.S. 87, 100 (1935) (rejecting equal protection challenge to state chain store license tax that "tax[ed] the large chains more heavily than the small ones"); *Miller v. Strahl*, 239 U.S. 426, 434 (1915) (rejecting equal protection challenge to exception in state statute requiring hotel keepers to take certain fire precautions for hotels with less than 50 rooms); *Engel v. O'Malley*, 219 U.S. 128, 137-38 (1911) (rejecting equal protection challenge to state licensing requirement for private banking businesses that did not apply to businesses in which the average sum received for safekeeping or transmission was more than \$500); *New York, N.H. & HR. Co. v. People of the State of New York*, 165 U.S. 628, 633-34 (1897) (rejecting equal protection challenge to exception in state statute regulating the heating systems of railroad passenger cars for railroads less than 50 miles in length); *Shell Oil Co. v. New York State Tax Commission*, 458 N.Y.S.2d 938, 943 (N.Y. A.D. 1983) (rejecting equal protection challenge to exemption for small refineries in tax on petroleum companies). See also *Morey v. Doud*, 354 U.S. 457, 465 (1957) ("That the Equal Protection Clause does not require that every state regulatory statute apply to all in the same business is a truism. For example, where size is an index to the evil at which the law is directed, discriminations between the large and the small are permissible") (citing *Strahl*, *O'Malley*, and *people of the State of New York*).

⁶⁵ See *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) (state laws are protectionist if they have either a "discriminatory purpose" or a "discriminatory effect").

peers of comparable size.⁶⁶ Both out-of-state wineries that fall below the cap and in-state wineries that fall below the cap can ship directly to in-state consumers. Correspondingly, both out-of-state wineries that produce in excess of the cap and in-state wineries that produce in excess of the cap all must chose their channel of distribution – *i.e.* either licensed wholesalers or direct to consumers.

The First Circuit concluded that Massachusetts' gallonage caps imposed a burden on interstate commerce and/or erected a barrier against trade in out-of-state wine. But did they? Could Massachusetts not have argued just as persuasively that its gallonage cap scheme had the effect of increasing the flow of interstate commerce in wine? As the Supreme Court noted, small wineries - which indisputably are by far the majority of total operating wineries nationwide and are increasing in number - have had difficulty gaining meaningful access (or access at all) to state three-tier systems because it is not always economically feasible for wholesalers to deal in small quantities. Massachusetts' gallonage cap law represented a pro-competitive legislative response to this recognized problem: the law increased access to the farm wine market in Massachusetts (witness the licensure of 26 new out-of-state farm wineries to join the commonwealth's 31 existing small farm wineries), but did so in a way that was consistent with, and preserved the integrity of, constitutionally the commonwealth's permissible three-tier system.

While some large wineries operating in the interstate conventional wine market may not be optimally served by the gallonage cap, they are not discriminated against relative to similarly-situated competitors. Large wineries may argue that having to use the three-tier system places them at a competitive disadvantage *vis-à-vis* wineries that can ship directly (due to the additional overhead and cost differential that the Supreme Court recognized in *Granholm*), but this argument has little force because the direct shipment privileges are being granted to remedy the fact that small wineries effectively have been excluded from the three-tier systems. More importantly, the large out-of-winerries suffer this ostensible disadvantage *vis-à-vis* both in-state wineries and the multitude of out-of-state wineries that fall below the caps. Again, because the gallonage cap law draws a size distinction, and does not draw an in-state/out-of-state distinction, any disadvantage suffered by the large, out-of-state wineries is not due to their residency status.

The fact that all of Massachusetts' in-state wineries fell below Section 19F's 30,000 gallonage cap should not in and of itself have led to the legal conclusion that the cap has a discriminatory effect on interstate commerce. As an initial matter, even if no in-state winery falls above a cap when the cap is enacted, there is of course the possibility - if not the expectation - that some in-state wineries will grow and exceed the cap in the future. In that event, the successful in-state wineries will be treated the same as their large, out-of-state peers: they will lose their direct shipping privileges or will be subject to whatever restrictions on these privileges the state imposes on wineries that are of comparable size.

⁶⁶ See *General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997) ("Conceptually, of course, any notion of discrimination [under the dormant Commerce Clause] assumes a comparison of substantially similar entities"); *Ford Motor Co. v. Texas Department of Transportation*, 264 F.3d 493, 500 (5th Cir. 2001) ("The [Supreme] Court's jurisprudence finds discrimination only when a State discriminates among similarly situated in-state and out-of-state interests").

Moreover, any analysis of the interstate effect of gallonage caps that grant direct shipping privileges to all or most in-state wineries must consider the undisputable fact that the caps also necessarily grant direct shipping privileges to a much larger number of small out-of-state wineries. The geographic reality is that during the pendency of the *Family Winemakers of California v. Jenkins* litigation, Massachusetts had only 31 wineries, and none of those produced over 30,000 gallons of wine. But there are by the First Circuit's own acknowledgment 4,713 small wineries located throughout the United States. Moreover, the overwhelming majority of large wineries as well as the small wineries are located in just a few states, *i.e.* California, Oregon New York and Washington. As a result, under the gallonage cap laws, wineries in Massachusetts can face substantial competition from small out-of-state wineries.⁶⁷ Given these circumstances, therefore, do the gallonage cap laws really "protect" the developing wine industry in Massachusetts from out-of-state competition?

In this regard, the fact that the gallonage caps benefit a significant subset of out-of-state wine producers - small producers – runs counter to the appellate court's conclusion that the gallonage caps burden or discriminate against interstate commerce. The U.S. Supreme Court unequivocally has held that "[t]he fact that the burden of a state regulation falls on some interstate companies does not, by itself, establish a claim of discrimination against interstate commerce" because the dormant Commerce Clause protects the interstate market, not particular interstate firms, from prohibitive or burdensome regulations."⁶⁸ The First Circuit itself has endorsed this same proposition repeatedly.⁶⁹

Accordingly, "interstate commerce is not subjected to an impermissible burden simply because an otherwise valid regulation causes some business to shift from one interstate supplier to another."⁷⁰ Here, the concern seems to be that Massachusetts' gallonage cap law will "shift business" from large out-of-state wine producers (who on a quantity basis have had full access to Massachusetts wine consumers through three-tier system) to small wine producers (the majority of whom have not). But that market change, which is

⁶⁷ Family Winemakers of California is a trade association that claims a membership of 740 Wineries, "dominated by small producers and vineyards. As recently as 2007, Family Winemakers stated on its website that more than 90% of its membership produced less than 10,000 cases annually, meaning at least 670 of its members during the pendency of the Massachusetts litigation (if not all of them) had volumes below Section 19F's 30,000 gallon cap, and therefore could obtain the same direct shipping privileges as the 31 existing Massachusetts wineries. See <http://www.familywinemakers.org/whoWeAre/whoWeAre.cfm>.

⁶⁸ *Exxon Corp. v. Maryland*, 437 U.S. 117, 126-28 (1978) (emphasis added).

⁶⁹ *E.g. Wine and Spirits Retailers, Inc. v. Rhode Island*, 481 F.3d 1, 15-16 (1st Cir. 2007); *Pharmaceutical Research and Manufacturers of America v. Concannon*, 249 F.3d 66, 84 (1st Cir. 2001) (the fact that a law may have "effects on the profits of . . . individual manufacturers" does not raise a dormant Commerce Clause Issue), *aff'd sub. nom.*, *Pharmaceutical Research and Manufacturers of America v. Walsh*, 538 U.S. 644 (2003).

⁷⁰ *Exxon*, 437 U.S. at 127.

attributable to legitimate public policy choices of the state legislatures, arguably raises no issue under the dormant Commerce Clause.⁷¹

Finally, opponents of the gallonage caps also might claim that even if the caps are not discriminatory in either purpose or effect, they are unconstitutional because they indirectly affect interstate commerce and the resulting burden on interstate commerce clearly exceeds the local benefits. As noted above, when a "statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."⁷²

A properly created legislative gallonage cap easily passes this test. States can effectuate legitimate local public interests by granting direct shipping privileges to small, but not large, wineries. When done properly, such limited exceptions to their three-tier distribution systems can be justified in order to ensure meaningful access to in-state wine markets for wineries that have been excluded, yet still preserve the integrity and related public benefits of the three-tier system for the vast majority of alcohol flowing to consumers.

Moreover, properly created gallonage caps can avoid burdening interstate commerce altogether. If markets are properly defined, and caps logically set, they can actually facilitate and expand interstate commerce. Unfortunately, that point does not necessarily come through so clearly in the *California Winemakers of California v. Jenkins*.

Conclusion.

Make no mistake -- *Family Winemakers of California v. Jenkins* is a complicated case, and the appellate judges had to grapple with many difficult issues. How do you measure a burden on interstate commerce? What is the proper definition of the interstate wine market? Whose comments best reflect the "intent" of a statute or law? Where is the appropriate middle ground between the government's reasonable efforts to secure legitimate public purposes, and the industry's right to insist on less intrusive methods for the achievement of those purposes?

The First Circuit has now answered those questions, and in doing so arguably has recalibrated the balance between the alcohol industry's commercial rights to access markets free from parochial discrimination, and the states' rights to regulate alcohol in a manner that adequately achieves legitimate public purposes. As for the Twenty-first Amendment, it appears on the stage but with no apparent role, amounting to little more than a passive observer in the adjudication process.

⁷¹ *Id.* (the dormant Commerce Clause does not protect "the particular structure or methods of operation" in a market).

⁷² *Pike*, 397 U.S. at 142.

Absent further appeal to the U.S. Supreme Court, *Family Winemakers of California v. Jenkins* will provide great comfort for industry members seeking to overcome state obstacles to a national marketplace for wine, and impose significantly greater evidentiary burdens on state alcohol regulators to demonstrate the legitimacy of their laws.