STATES' RIGHTS RISING!

Siesta Village Market LLC v. Steen

A Federal Appellate Court Upholds Texas' right to Prohibit Direct Sales and Shipment of Alcohol Beverages by Out-of-State Retailers, and Restores Judicial Respect for The Twenty-first Amendment.

By
Richard M. Blau, Esq.[1]
GRAY ROBINSON
ATTORNEYS AT LAW

On January 26, 2010, the U.S. Court of Appeals for the Fifth Circuit issued the new decade's second "Direct Shipping" decision in less than two weeks. The appellate court rejected a challenge under the dormant Commerce Clause of the U.S. Constitution against Texas' alcohol beverage laws denying out-of-state retailers the privilege of selling and delivering wine directly to Texas consumers. The Fifth Circuit's decision in *Siesta Village Market LLC v. Steen* was issued only 12 days after the U.S. Court of Appeals for the First Circuit issued its decision in *Family Winemakers of California v. Jenkins*, a "gallonage cap" case that overturned a Massachusetts law restricting direct sales and distribution rights only to licensed wineries that produced less than 30,000 gallons of grape wine per year. Both federal appellate courts dealt with states' rights to restrict interstate commerce in alcohol beverages where the result arguably impacts the ability of out-of-state industry members to compete effectively with their in-state counterparts. That, however, is as far as the similarities between the two cases go.

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[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.

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The Texas Litigation.

The Fifth Circuit's decision is the latest in a developing line of litigation cases where plaintiffs are challenging the traditional "three-tier system" of state regulation as a means of pursuing a national market for the retail sale of wine. These plaintiffs are filing strategically-targeted lawsuits in federal courts across America to challenge state alcohol beverage laws that restrict out-of-state retailers from directly selling and shipping wine to consumers while permitting licensed in-state retailers to do so.

Armed with the dormant Commerce Clause and wrapped in selected language from the U.S. Supreme Court's 2005 decision in *Granholm v. Heald*, the plaintiffs in *Siesta Village Market LLC. v. Steen* and similar cases have argued that an out-of-state retailer is entitled to the same rights as an in-state retailer. The Texas case brought by Siesta Village Market was the first major "second-generation *Granholm*" case brought by a consortium of interstate alcohol beverage retailers seeking to achieve for themselves what the Direct Shipping movement originally achieved for wineries.[2] Similar cases were filed and have since been litigated in federal courts asserting direct shipping rights for interstate wine merchants and other out-of-state alcohol beverage retailers in

[2] For example, the Specialty Wine Retailers Association (SWRA) states on its Web site that the organization "*stands for a free market in wine, unencumbered by protectionist state laws that prevent consumers from legally obtaining the wines they want. SWRA stands for a true national wine market in which consumers and retailers can transact business in an appropriately regulated milieu. This means that any adult consumer in any state should be allowed to legally purchase and have shipped to them any wine from any retailer in America.*"

Michigan[3] and New York,[4] as well as a case in California that was voluntarily dismissed by the plaintiffs before the court ever rendered a decision on the merits.[5]

What about this particular case? Texas is a heavily regulated jurisdiction when it comes to alcohol beverages. Siesta Village Market, a Florida wine retailer, and Wine Country Gift Baskets, a California online retailer, joined several individual consumers in suing the Texas Alcoholic Beverage Commission ("T-ABC") arguing that Texas' ban on the sale and shipment of wines by out-of-state retailers to Texas consumers violated the dormant Commerce Clause of the U.S. Constitution, as did the state's requirements that wine retailers must obtain a permit from the T-ABC and be residents of Texas. The plaintiff retailers in the case were arguing that they should be allowed to sell wine -- whether from California, Florida, or anywhere else -- directly to Texas consumers, on a level playing field with Texas-based retailers. The out-of-state retailers acknowledged the need for some kind of licensing, and stipulated that they would agree to be licensed as out-of-state retailers and accept all of the compliance responsibilities associated with such licensure.

The defendants, however, rejected such arguments. The T-ABC and state licensed wholesalers who intervened in the case argued that the U.S. Supreme Court's *Granholm* decision did not extend to the retail tier.

The T-ABC also argued that a qualitative difference existed between real and virtual retailers when it came to enforcement. How do state investigators conduct a surprise inspection of a retailer's licensed premises if it is located across the country, in a state where the regulator has no jurisdiction or investigatory authority?

On January 14, 2008, the U.S. District Court for the Northern District of Texas issued a lengthy decision that, like Solomon, appeared to cut the baby in half. Issued under the name *Siesta Village Market LLC v. Perry*,[6] the District Court's decision extended the concepts underlying *Granholm* to the retail tier and found that Texas' beverage laws facially discriminated against out-of-state retailers by not allowing them to deliver to

[3] *Siesta Vill. Mkt., LLC v. Granholm*, 596 F. Supp. 2d 1035 (E.D. Mich. 2008) (District Court rejected a Michigan law authorizing some in-state retailers to ship wine directly to consumers, while out-of-state retailers without a physical presence in Michigan could not; "While the [Granholm v.] *Heald* court did state that the three-tier system was an appropriate use of state power, it did not approve of a system that discriminates against out-of-state interests.").

[4] *Arnold's Wines, Inc. v. Boyle*, 571 F.3d 185, 188-90 (2d Cir. 2009) (Second Circuit affirmed decision of District Court upholding New York law that permitted an in-state alcoholic beverage retailer to deliver directly to consumers' residences in New York, using the retailer's vehicles or by using vehicles of a transportation company licensed by the State's liquor authority, even though the law did not extend comparable rights to out-of-state retailers; Commerce Clause constraints are strongest only with regards to producers, and State distinctions among in-state and out-of-state retailers, even to the point of requiring wholesalers and retailers to be present in and licensed by New York, constitute fundamental components of the three-tier system recognized by *Granholm* as "unquestionably legitimate.").

[5] *Knightsbridge Wine Shoppe, Ltd. v. Jolly*, Case No. 5:06-cv-2890-JF (N. D. Cal. 2006).

[6] 530 F. Supp.2d 848 (N.D. Tex. 2008).

consumers the way that licensed Texas retailers could. The District Court therefore ordered the T-ABC to allow out-of-state retailers to apply for licensure, so that they also could do what in-state Texas retailers do.[7]

But, applying that equality literally, the federal court also noted that Texas law requires all retailers to purchase their alcohol beverages from Texas wholesale distributors, and that requirement is facially non-discriminatory. Consequently, the decision in the case also holds that all retailers selling and delivering to Texas consumers in Texas must sell only wines that the retailer purchases from Texas wholesalers.

Requiring out-of-state retailers to purchase products from in-state wholesalers, and then allowing shipments from those retailers to Texas consumers was not the outcome anticipated by any of the litigants. Observers universally remarked that no interstate retailer's business model would sustain a legal obligation to purchase products from each market's respective state-licensed wholesale distributors; the economics of such an obligation would eliminate any marginal profitability that the retailer hoped to achieve through operating on an interstate basis.

At best, the District Court's Solomon-like decision was a Pyrrhic victory[8] for the plaintiffs. True, the federal trial judge extended the rationale of *Granholm* to the retail tier, albeit without any analysis and in contradiction of what was then the recently- issued New York federal court decision in a similar "second generation *Granholm* case" -- *Arnold's Wines, Inc. v. Boyle*.[9] However, the case was won at great cost, and arguably as beneficial to the defendant distributors in the sense that requiring the out-of-state retailers to purchase exclusively from Texas distributors effectively gutted the profitability and logistical value of the plaintiffs' business model. Also, the federal court's opinion reiterated the Supreme Court's oft-quoted statement in *Granholm* that the three-tier system is "unquestionably legitimate."

Perhaps not surprisingly, the "successful" plaintiffs appealed their own victory to the U.S. Court of Appeals for the Fifth Circuit, quickly followed by a cross-appeal from the defendants. Those appeals were combined and decided by the Fifth Circuit with a clear

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[7] *Id*. at 868-73.

[8] The phrase "Pyrrhic victory" traces its lineage back to the days of ancient Rome. King Pyrrhus of Epirus led his armies into war against the Romans more than two millennia ago, and technically "won" a pair of victories over the Romans in 280 BCE at Heraclea, and in 279 BCE at the battle of Asculum in Apulia. However, the loss of life on both sides was horrific, and Pyrrhus lost so many of his men that the "victory" turned out to be a catastrophic loss to the Epireans in the end. As the Greek-born, Roman chronicler Plutarch recounted in his *Histories:* "*... they had fought till sunset, both armies were unwillingly separated by the night, Pyrrhus being wounded by a javelin in the arm, and his baggage plundered by the Samnites, that in all there died of Pyrrhus's men and the Romans above fifteen thousand. The armies separated; and, it is said, Pyrrhus replied to one that gave him joy of his victory that one other such would utterly undo him. For he had lost a great part of the forces he brought with him, and almost all his particular friends and principal commanders; there were no others there to make recruits, and he found the confederates in Italy backward*."

[9] 571 F.3d 185 (2d Cir. 2009).

and unambiguous victory for the T-ABC and the wholesale distributors who intervened in the case.

The Issues Before the Fifth Circuit:

There were three distinct components to the lower court's ruling that were appealed to the Fifth Circuit. The appellate court summarized the issues before it as follows:

1. **Whether the lower court properly ruled that Texas' "personal import exception" to the three-tier system was unconstitutional because it impermissibly limited the quantity of wine that Texans traveling outside the state could purchase from out-of-state retailers who were not licensed by the Texas Alcoholic Beverage Commission (TABC) while allowing for unlimited consumer purchases from in-state licensed retailers?** This was an issue because the plaintiffs tried to use the personal import exception – a law that allows Texas residents traveling outside the state to bring back on their person limited quantities of alcohol beverages that they personally acquire without violating Texas' three-tier system – to argue that Texas was discriminating against unlicensed out-of-state retailers because those merchants presumably could only sell Texans the limited quantities allowed by the personal exception law, while in-state retailers were allowed to sell free of any quantity restrictions.

2. **Whether the lower court erred when ruling that Texas could not prohibit out-of-state retailers from selling and delivering wine directly to Texas consumers, when it simultaneously allowed in-state licensed retailers to do so**? This was the crux of the case, because it directly challenged the courts to define just how far industry members could extrapolate from *Granholm* and extend Commerce Clause scrutiny down the three-tier system before hitting resistance from the states' rights under the Twenty-first Amendment.

3. **Whether Texas licensed retailers must be citizens of Texas for at least one year prior to licensure?** This issue called into question Texas' historic requirement that licensees be Texas citizens or 51%+ owned by Texas citizens. Such restrictions violate the very spirit and intent of the Commerce Clause, and previously had been struck down by the Fifth Circuit for on-premises retailers[10] and wholesale distributors.[11] *Siesta Village Market LLC v. Steen* provided the federal appellate court with yet another opportunity to drive home the point that citizenship laws which blatantly discriminate against interstate commerce while serving no legitimate governmental purpose are ripe for overturning.

The Issues Not Decided By the Fifth Circuit:

[10] *Cooper v. McBeath*, 11 F.3d 547 (5th Cir. 1994).

[11] *Southern Wine & Spirits of Texas v. Steen*, 486 F.Supp. 2d 626 (W.D. Tex. 2007).

One of the noticeable aspects of the Fifth Circuit's decision is the sheer number of times the appellate court identified the issues and questions that it was not deciding. By its own acknowledgement, the decision identifies six specific points that the appellate judges decline to resolve:

1. Residency Requirement: "*The State does not appeal the voiding of the requirement and advised the district court that it will not enforce the citizenship rule. . . . That part of the* [lower court's] *judgment was not included in any notice of appeal and therefore has not been brought to us for reversal or affirmance.* "

2. Remedial Relief: "*Because we set aside the invalidation of the statutory provisions, issues about the remedial relief implementing the invalidation become moot. We thus do not discuss Wine Country's arguments on the remedy*." Likewise, "[t]*he last section in the Texas brief explains its embrace of the remedy that Wine Country rejects. There is no need to review those arguments.*"

3. Legitimacy of State Law's Purported Purposes: "*Texas also argues that the direct shipping laws are justified by legitimate state interests. It alleges valid local public interests exist and the law has only incidental effects on interstate commerce. Its policy justifications include the State's need to access retail sites for inspection and enforcement, which can uncover illegal activities – specifically regarding alcohol or more generally such as for money laundering – and the State's goals of promoting temperance, insuring tax collections, and assuring the separation between the three tiers. We do not reach the policy justifications, as our reversal is for other reasons*."

   Similarly, *The States* [*i.e*. New York and Michigan in the *Granholm v. Heald* case] *claimed two purposes – prevention of underage drinking and the need for taxes. Id. at 489. The* [U.S. Supreme] *Court found that neither had sufficient evidentiary support to save those States' laws. Id. at 490-92. We do not discuss this point because we determine that the Texas provisions are constitutional and do not need to be saved*."

   Further on in the opinion, the Fifth Circuit reiterated the limited scope of its analysis: "*Having found the Texas laws discriminatory, the* [lower] *court turned to the question of whether the State could show legitimate local purposes, not obtainable by nondiscriminatory alternatives, to justify the discrimination. We do not ultimately reach that analysis, so we do not summarize it here*."

4. History of the Twenty-first Amendment and its Judicial Construction: "*The understanding of a State's power under the Twenty-first Amendment may have changed since the 1933 ratification, but we need not review seventy-five years of history. Instead, we rely primarily on the latest Supreme Court explanation.*"

5. Rights and Restrictions Applicable to Wineries and Producers: "*We first note what is not in issue. The discrimination that Granholm invalidated was a State's allowing its wineries to ship directly to consumers but prohibiting out-of-state wineries from doing so. Texas grants in-state and out-of-state wineries the same rights. TEX. ALCO. BEV. CODE §§ 54.01-54.12. Such discrimination – among producers – is not the question today*."

6. Defining the Boundaries of "Retailing Activity" Under the 3-Tier System of Regulation: "*We pull back from any effort to define the reach of a traditional three-tier retailer. Instead, we resolve whether what Texas has allowed here is so substantially different from what retailing must include as not to be third-tier retailing at all. . . . The rights of retailers at a minimum would include making over-the-counter sales. Wine Country's argument implies that is where Granholm-approved retailing ends and where the potential for discrimination begins. We disagree. Texas has adjusted its controls over retailers by allowing alcoholic beverage sales to customers other than those who walk into a store. Still, sales are being made to proximate consumers, not those distant to the store. Retailers are acting as retailers and making what conceptually are local deliveries.*"

So, what exactly did the Fifth Circuit decide? Two distinct issues, actually; one core, and the other collateral.

The core issue of the case was whether Texas can permit in-state retailers to directly sell and deliver wine to Texas consumers, while denying that privilege to out-of-state retailers. This was the issue appealed by all parties, and the Fifth Circuit handled it in the following way:

> We discuss only the cross-appeal arguments presented by Texas. First, we will examine closely the United States Supreme Court opinion that spoke strongly and supportively about the three-tier system for distribution of alcohol. We then look at what three subsequent opinions from other courts have said about it. We then briefly review the district court's decision, and finally we apply our analysis to it.

What followed in the decision was a straightforward review of *Granholm v. Heald*, followed by scrutiny of subsequent federal appellate court decisions addressing what legal experts and industry observers characterize as the "second-generation *Granholm* cases," *i.e*. cases where plaintiffs seek to extend to interstate retailers the Commerce Clause protections acknowledged by the *Granholm* court as belonging to wine producers.

What the Fifth Circuit Decided:

In summary, the federal appellate court ruled that:

1. ***Granholm* unambiguously upheld the unquestionable legitimacy of the traditional three-tier system of state alcohol regulation**. According to the appellate court:

> Because of *Granholm* and its approval of three-tier systems, we know that Texas may authorize its in-state, permit-holding retailers to make sales and may prohibit out-of-state retailers from doing the same. Such an authorization therefore is not discrimination in *Granholm* terms.

2. **The Commerce Clause protections associated with *Granholm*, including the intolerance of regulatory discrimination that unduly burdens interstate commerce by disadvantaging out-of-state producers relative to their in-state counterparts and hinders product access to in-state markets, are protections that shield producers and products, but not retailers.** According to the appellate court:

> *. . . Granholm*, concerned wineries*, i.e.,* the producers of the product traveling in commerce. The producers in a three-tier system often are not located in the State in which the sales occur. The traditional three-tier system, seen as one that funnels the product, has an opening at the top available to all. The wholesalers and retailers, though, are often required by a State's law to be within that State. The distinction is seen in Texas law. It allows wineries themselves, located for example in California or Florida as are the retailer plaintiffs, to ship directly to Texas consumers.
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> Texas argues that the following language in *Granholm* certifies the constitutionality of the three-tier system that most States use, and is the lens through which the concept of discrimination needs to be seen:
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> > The States argue that any decision invalidating their direct-shipment laws would call into question the constitutionality of the three-tier system. This does not follow from our holding. "The Twenty-first Amendment grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system." A State which chooses to ban the sale and consumption of alcohol altogether could bar its importation; and, as our history shows, it would have to do so to make its laws effective. States may also assume direct control of liquor distribution through state-run outlets or funnel sales through the three-tier system. We have previously recognized that the three-tier system itself is "unquestionably legitimate." State policies are protected under the Twenty-first Amendment when they treat liquor produced out of state the same as its domestic equivalent. The instant cases, in contrast, involve straightforward

> attempts to discriminate in favor of local producers. Id. at 488-89.
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> **That language may be dicta. If so, it is compelling dicta**. (Citations omitted; Emphasis added).

3. **The trial court erred by extending the principles of Commerce Clause protection enunciated in *Granholm* to members of the retail tier**. According to the appellate court:

> The discrimination that *Granholm* invalidated was a State's allowing its wineries to ship directly to consumers but prohibiting out-of-state wineries from doing so. Texas grants in-state and out-of-state wineries the same rights. Such discrimination – among producers – is not the question today. When analyzing what else is invalid under the Supreme Court's *Granholm* reasoning, we find direction in a source for some of the Court's language. The Court quoted a 1986 precedent that "a comprehensive system for the distribution of liquor within [North Dakota's] borders" was "unquestionably legitimate." quoting *North Dakota v. United States.* North Dakota employed a three-tier system similar to that in Texas, in which producers sell to state-licensed wholesalers, who sell to state-licensed retailers. That sort of system has been given constitutional approval. The discrimination that would be questionable, then, is that which is not inherent in the three-tier system itself. If *Granholm's* legitimizing of the tiers is to have meaning, it must at least mean that. The legitimizing is thus a caveat to the statement that the Commerce Clause is violated if state law authorizes "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." Therefore, the foundation on which we build is that Texas may have a three-tier system. That system authorizes retailers with locations within the State to acquire Texas permits if they meet certain eligibility requirements. Those retailers must purchase their alcoholic beverages from Texas-licensed wholesalers, who in turn purchase from producers. Each tier is authorized by Texas law and approved by the Twenty-first Amendment – so says *Granholm* – to do what producers, wholesalers, and retailers do. . . .
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> *Granholm* prohibited discrimination against out-of-state ***products*** or ***producers***. Texas has not tripped over that bar by allowing in-state ***retailer*** deliveries. (Emphasis original); (Citations omitted).

4. **The lower court (like the First Circuit in *Family Winemakers of California v. Jenkins*) did not consider the Twenty-first Amendment to have controlling influence over the assessment of the state alcohol regulation at issue. This, according to the Fifth Circuit, was a mistake when the case deals with retailers.** According to the appellate court:

> The problem with the [Appellant's] argument is that it ignores the Twenty-first Amendment. When analyzing whether a State's alcoholic beverage regulation discriminates under the dormant Commerce Clause, a beginning premise is that wholesalers and retailers may be required to be within the State. Starting at that point, we see no discrimination in the Texas law.

5. **In light of its construction of *Granholm*, the claims of plaintiffs/appellants regarding Texas' personal import exception are unfounded and therefore rejected.** Just as the **Twenty-first** Amendment makes the three-tier system "unquestionably legitimate" for regulating the flow of alcohol within a state's borders, it also condones a state's prerogative to allow its citizens a limited exception from three-tier restrictions for alcohol that the individual purchases for personal consumption while outside the state. According to the Fifth Circuit:

> . . . Texas did not, indeed can not, limit the number of alcoholic beverages consumers may buy at an out-of-state retailer. Any purchase limits would have to come from the other State's laws. The barrier Texas imposes is at its border.
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> We conclude that the incidental effect on foreign retail sales resulting from limits on quantities to be brought into Texas is at worst an acceptable balancing. The interests of Texas consumers in purchasing alcoholic beverages outside of Texas are recognized, but the State validly insists that the vast majority of the alcoholic beverages consumed in Texas be obtained through its own retailers. In effect, Texas has granted a limited exception to the three-tier system. We find no constitutional defect. (Citation omitted.).

6. **On the issue of residency, the Fifth Circuit effectively took a walk rather than taking the opportunity to hit a home run on closing once and for all the citizenship quagmire.** Substantial case law, including several of the Fifth Circuit's own precedents, make clear that requiring a licensee to hold state citizenship is impermissible absent a very compelling government reason. Yet, instead of holding unambiguously that such requirements are unconstitutional, the appellate court ruled that no express determination was required because:

> The district court in the present case declared the requirements unconstitutional as applied to retailers. The State does not appeal the voiding of the requirement and advised the district court that it will not enforce the citizenship rule.

Harmonizing the Decisions of the First and Fifth Circuits:

An interesting side note concerns the only direct connection between the Fifth Circuit's decision and the First Circuit opinion that preceded it. In *Family Winemakers of*

California v, Jenkins, the First Circuit cursorily acknowledged and summarily dismissed the opinions of two other federal courts that had directly addressed and upheld state wine laws based on gallonage caps. In a lowly footnote offering no explanation, the First Circuit said:

> 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).

Ironically, or perhaps not so, the Fifth Circuit returns the favor, making a similar acknowledgment of the First Circuit's recent ruling in one of its own footnotes:

> A fourth decision analyzing *Granholm* was recently released, but we find nothing in it to affect our reasoning. *Family Winemakers of Cal. v. Jenkins*, No. 09-1169, 2010 WL 118387, at *5-15 (1st Cir. Jan. 14, 2010) (state law granting distribution rights to "small" wineries was held to discriminate in favor of in-state wineries, all of whom were "small").

Irony aside, are the two decisions reconcilable? Two distinct rationales suggest that they might be harmonized.

1. ***The "Differentiation Between Wine Markets" Rationale***: The First Circuit's decision dealt with wine producers and their products' access to a state market. At issue in *Family Winemakers of California v. Jenkins* was the constitutionality of a Massachusetts law restricting producers' direct sales and shipping rights based on the licensed winery's size, rather than location: "small" wineries were allowed full distribution options and discretion, while "large" wineries had to make a Devil's choice between distributing their products solely through state-licensed wholesalers, or alternatively selling their products only via direct distribution to Massachusetts consumers.

Although the First Circuit criticized Massachusetts repeatedly for failing to articulate the legitimate purposes of its alcohol laws, the briefs in the case suggest that one key concern was supporting small family farms that produce and sell wine either as a primary crop or a secondary cash generator. The law's legislative history indicates its authors wanted to promote the ability of small wineries, wherever they are located, to access Massachusetts consumers while still retaining a regulatory system where the bulk of the commercial wine marketed and sold in Massachusetts flowed through the commonwealth's traditional three tier system. While the record presented to the First Circuit may not have shown it clearly, the Massachusetts legislators arguably defined the market for small family farm wines as being distinct from the market for nationally-marketed wines produced by large commercial wineries.

Perhaps because of the inadequate record before it, the First Circuit determined that small and large wineries all compete in the same market. The determination that all wines

compete in a single market in turn led inevitably to the conclusion that Massachusetts discriminated against large wineries and unduly impeded their ability to compete against small wineries – and specifically the wineries of Massachusetts, all of which qualified as "small" under the law.

In contrast, the Fifth Circuit in *Siesta Village Market LLC v. Steen* differentiated between relevant markets, but it did so drawing the line based on tier rather than size. Specifically, the Fifth Circuit found that wine sales made by wineries, whether in-state or out-of-state, large or small, were qualitatively different from sales made by retailers. According to the Fifth Circuit:

> The producers in a three-tier system often are not located in the State in which the sales occur. The traditional three-tier system, seen as one that funnels the product, Granholm, 544 U.S. at 489, has an opening at the top available to all. The wholesalers and retailers, though, are often required by a State's law to be within that State. The distinction is seen in Texas law. It allows wineries themselves, located for example in California or Florida as are the retailer plaintiffs, to ship directly to Texas consumers. . .
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> Because of *Granholm* and its approval of three-tier systems, we know that Texas may authorize its in-state, permit-holding retailers to make sales and may prohibit out-of-state retailers from doing the same. Such an authorization therefore is not discrimination in *Granholm* terms. The rights of retailers at a minimum would include making over-the-counter sales. Wine Country's argument implies that is where *Granholm*-approved retailing ends and where the potential for discrimination begins. We disagree. Texas has adjusted its controls over retailers by allowing alcoholic beverage sales to customers other than those who walk into a store. Still, sales are being made to proximate consumers, not those distant to the store. Retailers are acting as retailers and making what conceptually are local deliveries.

The Fifth Circuit's reliance on face-to-face, "over-the-counter" sales does have resonance in alcohol law jurisprudence. For example, when a federal judge in Arkansas dismissed a Direct Shipping lawsuit in 2007 challenging the state's ban on out-of-state direct-to-consumer wine sales, the decision was based in large part on the differentiation between the market for small farm wines versus nationally-marketed commercial wines.

In 2005, Scott Beau filed the lawsuit in the US District Court for the Eastern District of Arkansas, arguing that the state's ban on direct shipments from out-of-state wineries discriminated against interstate commerce. Michigan winery Wyncroft LLC also was a plaintiff in the lawsuit, which was styled as *Beau v. Moore*.[12] At the time, Arkansas prohibited all wineries from shipping direct to Arkansas consumers, but allowed small

[12] 2007 WL 3231890 (E.D. Ark. 2007).

wineries to get a license to sell face-to-face to Arkansas retailers/restaurants and/or to consumers at their licensed premises or at fairs and food festivals. The plaintiffs claimed this face-to-face requirement was impermissible discrimination in favor of in-state vintners.

In ruling for the state and dismissing the plaintiffs' claims, U.S. District Judge Susan Webber Wright drew a distinction between a market where the consumer must travel to a winery versus one "*in which a consumer may order wine on the Internet for home delivery*." According to the court in *Beau v. Moore*:

> [P]laintiffs attempt to equate two distinct commercial activities: selling small farm winery wine in over-the-counter transactions on the premises of any winery located in Arkansas and selling any wine, from any place, for direct-shipment delivery. . . A market in which consumers must travel to a winery to purchase wine is distinct from a market in which a consumer may order wine on the Internet for home delivery."[13]

The Arkansas federal court went on to conclude that: "*because there is no actual or prospective competition between in-state and out-of-state wineries in the area of direct-shipment sales to Arkansas consumers, "there can be no local preference, whether by express discrimination against interstate commerce or undue burden upon it, to which the dormant Commerce Clause may apply*."[14]

The differentiation between wine markets is a concept that has been employed either directly or indirectly by other courts as well, primarily in addressing challenges to state wine laws that required face-to-face sales.[15] In fact, the First Circuit itself invoked such an analysis in its 2007 decision of *Cherry Hill Vineyard, LLC v. Baldacci*,[16] which upheld Maine's law against direct wine shipments to consumers on grounds that no discrimination existed because all wineries, in-state and out-of-state, were prohibited from making such deliveries. In that case, the First Circuit upheld the state law that allowed Maine farm wineries to bypass wholesalers and sell to consumers in direct face-to-face transactions because it recognized that farm wines represent a different product market relative to nationally-marketed commercial wines:

> Sweeping aside rhetorical flourishes, the plaintiffs have proffered no evidence that permitting farm wineries to sell only face to face, either on

[13] *Id*. at p. 4.

[14] *Id*. at p. 5. (Citations omitted).

[15] See, e.g. *Baude v. Heath*, Civ. No. 05-0735, 2007 WL 2479587, at *15 (S.D.Ind. 2007), *rev'd on other grounds*, 538 F.3d 608 (7th Cir. 2008) ; *Jelovsek v. Bresden*, 482 F.Supp.2d 1013, 1020-21 (E.D.Tenn. 2007), *rev'd on other grounds* 545 F.3d 431 (6th Cir.(Tenn.) Oct 24, 2008); *Hurley v. Minner*, Civ. No. 05-826, 2006 WL 2789164, at *6 (D.Del. Sept. 26, 2006).

[16] 505 F.3d 28 (1st Cir. 2007).

> premises or at approved in-state locations, discriminates against interstate commerce. There is no evidence that . . . Maine consumers substitute wines purchased directly from Maine vineyards for wines that they otherwise would have purchased from out-of-state producers. . . . And, finally, nothing contained in the stipulated record suggests that the locus option somehow alters the competitive balance between in-state and out-of-state firms
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> The substitution scenario is further weakened by the fact that the plaintiffs 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.[17]

Perhaps, had Massachusetts prepared a record of evidence emphasizing the distinction between the market for small family farm wines versus the market for nationally-promoted commercial wines, the First Circuit might not have concluded that Massachusetts' wine law unduly restricted interstate commerce through its discrimination against large wineries.

2. ***The "Partial Relinquishment of States' Rights and Core Powers" Rationale***: In addition to examining how the courts define the relevant market place, another basis exists by which the recent decisions of the First and Fifth Circuits might be harmonized. Under this alternative theory, the salient inquiry is whether the state is acting in an area where it already has relinquished some of its States' Rights and "core powers" authority?

In *California Family Winemakers v. Jenkins*, the First Circuit ruled that Massachusetts' statutory restrictions on "large wineries" violated the dormant Commerce Clause of the U.S. Constitution by unfairly discriminating in favor of Massachusetts wineries to the detriment of "large" wineries, all of which were located outside the commonwealth. In reaching its decision, the First Circuit rejected the government's arguments that the Twenty-first Amendment enhanced the commonwealth's right to pass such laws, and questioned whether "the core powers doctrine" which has evolved over decades of jurisprudence construing Section 2 of the Twenty-first Amendment had any continuing vitality. Basically, the argument came down to this: Having elected to allow any wine suppliers the right to self-distribute and/or directly sell and ship wine to end-use consumers outside the established three-tier system, the state effectively waived whatever enhanced authority it possessed over that tier/segment under either the Twenty-first Amendment or the doctrine of States' Rights. As the First Circuit noted:

[17] *Id* at 37. (Citations and footnote omitted).

In contrast, the Fifth Circuit in *Siesta Village Market LLC v. Steen* dealt with laws and regulations that sought to allocate privileges and restrictions for members of the retail tier. Texas already "leveled up" to allow out-of-state wineries to sell directly to Texas residents on a par with in-state wineries, thus achieving compliance with the literal dictates of *Granholm*. However, the Texas Legislature never compromised its regulatory rights relative to the retail tier. Where the Fifth Circuit seems to draw the line, along with the U.S. Courts of Appeals for the Second and Fourth Circuits, is extending those Commerce Clause compromises to the states' rights to regulate wholesale distributors and retailers.

Is there some legal basis for the notion that States' Rights or core powers can be waived? Let's start with the basics, *i.e.* understanding what is meant by "States' Rights," "core powers" and "core concerns."

What are "States' Rights?" This term references the doctrine of jurisprudence based on the Tenth Amendment to the U.S. Constitution, which states, "*The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people*." Over the years, the concept has taken on different meanings. Alexander Hamilton and the Federalist party favored a narrow interpretation that would support a strong central government deriving its authority from implied as well as express powers contained in the Constitution; Abraham Lincoln, Franklin D. Roosevelt and most modern presidents adhere to this construction. An alternative view espoused a broad understanding of States' Rights, predicated on absolute state sovereignty that was embraced by the so-called "strict constructionists" of the U.S. Constitution; these ranged from Thomas Jefferson through Jefferson Davis to Twentieth Century conservative leaders like Governor George Wallace, who insisted that all powers not specifically granted the federal government are reserved to the states.

While the doctrine of States Rights was revived by Southern opponents of the federal civil-rights civil rights movement in the mid-Twentieth Century, it is not exclusive to any particular region or political party. The vast increase in the powers of the federal government at the expense of the states, resulting from the incapacity of the states to deal with the complex problems of modern industrial civilization, has led to renewed interest in states' rights.

In the 1980s and 90s, states' rights proponents, under the banner of "federalism" or "the New Federalism," attacked the great increase in federal government powers that had occurred since the New Deal programs of the administration of Franklin Delano Roosevelt. Those proponents found a receptive ear in the U.S. Supreme Court under Chief Justice William Rehnquist. As Kathleen Sullivan, a former dean of the Stanford Law School and one of the lawyers who argued the *Granholm v. Heald* case before the Court noted in a 2006 law review article, the "Rehnquist Court" dramatically reversed the trend away from States' Rights that had developed over the century since the Civil War:

> For most of the twentieth century, the federal and state governments had been left to bargain or fight over their relationship in the realm of

> politics. The Rehnquist Court, by contrast, increasingly held that this relationship was a matter to be refereed in the courts. The Court grounded this approach in the history of the Founding: "Dual sovereignty is a defining feature of our Nation's constitutional blueprint. States, upon ratification of the Constitution, did not consent to become mere appendages of the Federal Government. Rather, they entered the Union with their sovereignty intact." In addition, the Court suggested that this relationship required judicial protection, not mere political self-help: "Federalism was our Nation's own discovery. The Framers split the atom of sovereignty. It was the genius of their idea that our citizens would have two political capacities, one state and one federal, each protected from incursion by the other."
>
> For the most part, the Rehnquist Court's federalist revival restrained the federal government from incursion upon the states. In some lines of decision, the Court held that Congress had exceeded the scope of its powers. In others, it held that a federal law had wrongly intruded upon the sovereign autonomy of the states. Whether enforcing such internal or external limits on federal power, the Rehnquist Court took significant steps to rebalance power between the state and federal governments.[18]

It is unclear how that judicial philosophy will play under the auspices of Chief justice Roberts. What is clear, though, is that the doctrine of States' Rights remains more than a historical artifact of American jurisprudence.

What are core powers? Section 2 of the Twenty-first Amendment speaks to importation, transportation, delivery and use:

> The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."[19] (Emphasis added).

Beyond those core powers, the history of alcohol regulation in America also makes clear that States' Rights in the area of intoxicating liquors includes police powers to assure orderly markets.[20] Temperance and orderly markets obviously are "core concerns" of the Twenty-first Amendment, but the meaning of those terms has faded over the decades.

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[18] Sullivan, K., *From States' Rights Blues to Blue States' Rights: Federalism After the Rehnquist Court*. 75 Fordham L. Rev. 799 (2006) (citations omitted).

[19] U.S. Const. amend. XX1, cl. 2.

[20] *See, e.g., North Dakota v. United States*, 495 U.S. 423, 432 (1990) (plurality opinion*); Joseph E. Seagram & Sons, Inc. v. Hostetter*, 384 U.S. 35, 47-48 (1966), overruled on other grounds by *Healy v. The Beer Institute,* 491 U.S. 324, 342-43 (1989); *Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848, 852-57 (7th Cir. 2000).

There seems to be no common definition among the different states as to what is required to establish an "orderly market" for alcohol beverages. However, past regulatory patterns & practices, as well as statutes and case law suggest the following governmental objectives are considered instrumental to maintaining an orderly market for alcohol:

- Raising revenue and efficiently collecting taxes;
- Directly or indirectly regulating prices as a means of tempering consumption;
- Prohibiting sales to unlawful consumers (minors and intoxicated persons);
- Assuring the integrity of products against counterfeiting, bootlegging, adulteration and contamination;
- Providing for a distribution environment that effectively serves the public, *e.g.* making sure that distribution encompassed less-profitable rural areas as well as more lucrative urban markets; and
- Retaining jurisdiction to restrict or prohibit sales and consumption in areas where mandated by the will of the people.

With these States' Rights and core powers in mind, the reconciliation between the First and Fifth Circuits arguably rests with an awareness of decisions by States to cede some, but not all, of these powers. Can states do that?

Our jurisprudence is filled with examples where sovereign entities relinquish certain regulatory powers in part to accommodate competing interests, while still retaining others to preserve legitimate government objectives. A common example of increasing frequency involves states' relaxation of long-standing prohibitions against gambling; specific exceptions are created to allow certain types of gambling, or to allowing gambling in certain limited geographic areas, while general restrictions remain in place.[21]

The same circumstances exist today with alcohol, and are at issue in both the First and Fifth Circuit cases. In Massachusetts and many other states, legislatures have passed direct shipping laws to balance the public's need for alcohol regulation against the public's desire to promote small wineries. In contrast, few states have relaxed their core powers/core purposes regulation of the alcohol industry's distribution and retailing tiers.

The difference is critical for judges, because alcohol laws regulating in areas where the sovereign has ceded its States' Rights/core powers/core purposes authority are subject to greater scrutiny under the dormant Commerce Clause; that's how the First Circuit called the case. On the other hand, alcohol laws that regulate in areas where the sovereign retains its full, unrelaxed core powers/core purposes power remain at their strongest, and

[21] *See, e.g. Fitzgerald v. Racing Association of Central Iowa*, 539 U.S. 103 (2003) (Iowa racetrack owners objected to state tax that imposed higher tax rate on racetrack gambling than slot machine gambling, claiming the disparate tax rates denied them "the equal protection of the laws," in violation of the U.S. Constitution's Fourteenth Amendment; U.S. Supreme Court upheld the state's authority to regulate riverboats and racetracks differently); *Chickasaw Nation v. United States*, 534 U.S. 84 (2001) (Indian Gaming Regulatory Act does not exempt sovereign Indian Nations from paying taxes that States are exempt from paying).

can survive a Commerce Clause challenge so long as the sovereign demonstrates a rational basis for the law' existence; that's the call made by the Fifth Circuit.

Although seemingly at cross purposes, a sovereign state's decision to relax one component of a regulatory system empowered under the exercise of States' Rights or core powers does not render the remaining regulatory system void. 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. Thus, traditional three-tier system regulation can remain in place even if it does not uniformly regulate every drop of alcohol sold and consumed in the state. The challenge is to assure that alcohol regulations involving areas where the sovereign has ceded some of its authority under States' Rights or core powers meet their constitutional responsibilities; these laws have less immunity from Commerce Clause challenge, and are susceptible to a higher level of judicial scrutiny.

The First Circuit struck down the Massachusetts law because: (1) the commonwealth had ceded some of its core powers over wine suppliers by relaxing regulations for small wineries; and (2) the regulation in question discriminated against out-of-state products and their out-of-state producers to the advantage of in-state interests, and in doing so ran afoul of the dormant Commerce Clause. In contrast, the Fifth Circuit upheld the Texas law prohibiting direct shipments by out-of-state retailers because the Texas Legislature had not ceded or otherwise relinquished any of its powers relative to the alcohol wholesale distributors and retailers of the state's longstanding three tier system; thus even if the arguable effect of the regulation treated out-of-state retailers differently from in-state retailers, the state alcohol law prevailed because there had been no ceding of core powers by the state relative to the retail tier of the "unquestionably legitimate" three-tier system.

What Does It All Mean?

All of this analysis may become moot if the plaintiffs/appellants in *Siesta Village Market LLC v. Steen* get their way. In a filing dated February 9, 2009, those appellants filed their Petition for En Banc Review with the Fifth Circuit. In asking for reconsideration of the Fifth Circuit's decision against them, the appellants argue that three-judge panel's recent opinion errs in two areas of exceptional importance:

> .
> First, the panel opinion contradicts substantive holdings of the Fifth Circuit and the Supreme Court by permitting the State of Texas to discriminate between in-state and out-of-state participants in interstate commerce. In so doing, the panel chose to follow erroneous Second Circuit case law rather than binding local and Supreme Court precedent. Second, the panel opinion applies an analytical method contrary to the method mandated by Fifth Circuit precedent in Commerce Clause cases such as this one. The panel's novel methodology threatens this court's ability to adjudicate future cases consistently and correctly.

It's way too early to tell if the appellants will be successful, or even if the Fifth Circuit will grant their request for reconsideration. To get the attention of all sixteen sitting appellate judges on the Fifth Circuit, at least one must agree to have the case reconsidered.

Even if the petition is granted, securing a reversal will not be easy. The appellants assert that prior decisions of the Fifth Circuit run contrary to last month's decision in *Siesta Village Market LLC v. Steen,* but those two cases were decided in contexts that were distinguishable from the issue of direct shipping rights for out-of-state retailers.

Cooper v. McBeath[22] was a residency requirement case, which struck down the notion that only residents of Texas could be licensees. However, residency requirements may be distinguishable from direct shipping regulations because retailers who were freed from Texas' old residency requirement nevertheless had to comply with all the regulations imposed on licensees by the Texas three-tier system of regulation. For example, the rationale that a state alcohol regulator needs to be able to physically inspect a licensed retail vendor arguably remains valid whether the retailer is a Texas citizen or a foreign corporation lawfully doing business in Texas. Likewise, the legislature's dictate that a retailer should sell alcohol to consumers on a face-to-face transactional basis is unaffected by residency, but very much affected by direct shipping exceptions.

The other case, *Dickerson v. Bailey*[23] is a direct shipping case. However, it relates specifically to suppliers, not retailers. The Fifth Circuit in *Siesta Village Market LLC v. Steen* expressly addressed *Dickerson*, and distinguished it. According to the three-judge panel:

> A decision by this court foreshadowed *Granholm*. In it, we struck down Texas laws that allowed Texas wineries to ship directly to consumers and thus bypass going first to a wholesaler, but these laws prohibited out-of-state wineries from doing the same. *Dickerson v. Bailey*, 336 F.3d 388, 406-7 (5th Cir. 2003). The Texas legislature responded to Dickerson by authorizing wineries wherever located to ship directly to Texas consumers once they were issued the appropriate permit. TEX. ALCO. BEV. CODE §§ 54.01-.12.
>
> We disagree with Wine Country that *Dickerson* answers today's questions. That precedent, as did *Granholm*, concerned wineries, *i.e.*, the producers of the product traveling in commerce. . . .
>
> . . . *Granholm* dealt specifically with state laws treating in-state and out-of- state producers of alcohol differently. This present appeal involves retailers. Since *Granholm,* other decisions from outside this Circuit have addressed that precedent's applicability to retailers who wish to ship wine into other States. . .

[22] *Cooper v. McBeath*, 11 F.3d 547 (5th Cir. 1994).
[23] 336 F.3d 388 (5th Cir. 2003).

> . . . Such discrimination – among producers – is not the question today. When analyzing what else is invalid under the Supreme Court's *Granholm* reasoning, we find direction in a source for some of the Court's language. The Court quoted a 1986 precedent that "a comprehensive system for the distribution of liquor within [North Dakota's] borders" was "unquestionably legitimate." North Dakota employed a three-tier system similar to that in Texas, in which producers sell to state-licensed wholesalers, who sell to state-licensed retailers. That sort of system has been given constitutional approval. The discrimination that would be questionable, then, is that which is not inherent in the three-tier system itself. If *Granholm's* legitimizing of the tiers is to have meaning, it must at least mean that. The legitimizing is thus a caveat to the statement that the Commerce Clause is violated if state law authorizes "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."
>
> Therefore, the foundation on which we build is that Texas may have a three-tier system. That system authorizes retailers with locations within the State to acquire Texas permits if they meet certain eligibility requirements. Those retailers must purchase their alcoholic beverages from Texas-licensed wholesalers, who in turn purchase from producers. Each tier is authorized by Texas law and approved by the Twenty-first Amendment – so says Granholm – to do what producers, wholesalers, and retailers do. (Citations omitted).

An arguably stronger basis for challenging the three-judge panel's decision in *Siesta Village Marketing LLC v. Steen* lies in the second bone of contention – that the appellate judges failed to follow the usual step-by-step analysis for analyzing a Commerce Clause challenge to an allegedly discriminatory state law. The appellants have a point that the Fifth Circuit's opinion does not provide that customary analysis in a straightforward manner.

However, in reopening the issue, what the appellants may wind up with is a more defined opinion that hands them a more particularized defeat. The text of the existing opinion makes clear that the Fifth Circuit judges who decided the *Siesta Village Marketing LLC v. Steen* case were impressed by the rationale enunciated by the U.S. Court of Appeals for the Second Circuit in *Arnold's Wines, Inc. v. Boyle*.[24] They expressly noted with undisguised approval:

> The Second Circuit started with a recognition that the Twenty-first Amendment does not authorize all alcohol regulation. Any discrimination between in-state and out-of-state alcohol products or producers must reasonably further a legitimate state interest "that cannot adequately be

[24] 571 F.3d 185 (2d Cir. 2009).

> served by reasonable nondiscriminatory alternatives." The court's focus on "products or producers" is the central debate: how much further, if at all, beyond products and producers do the anti-discrimination principles go?
>
> The Second Circuit held products and producers are the limit. It described plaintiffs' arguments as simplistic analogies to the *Granholm*-identified discrimination. A State's making distinctions among in-state and out-of-state retailers, and even requiring wholesalers and retailers to be present in and licensed by New York, were fundamental components of the three-tier system authorized in *Granholm*.
>
> The court concluded that the New York laws permitting only in-state retailers to ship directly to consumers were in "stark contrast" to the laws struck down in Granholm, which "created specific exceptions to the states' three-tier systems favoring in-state producers." It found that the production-related discrimination involved in *Granholm* "was exactly the type of economic protectionist policy the Commerce Clause sought to forestall, and where the *Granholm* Court drew the line."
>
> The line drawn by the court was between the broad state powers under the Twenty-first Amendment "to regulate the transportation, sale, and use of alcohol within their borders," and any "attempts to discriminate in favor of local products and producers." It held New York's laws were evenhanded in their control of "importation and distribution of liquor within the state," and that made the dormant Commerce Clause all but irrelevant.

The appellants must be prepared to push the Fifth Circuit off this position, and convince the entire appellate court that the Second Circuit's recognition of the unique nature of alcohol was misplaced.

CONCLUSION

Siesta Village Market LLC v. Steen is one of the "second-generation *Granholm*" lawsuits that were filed to try and extend the U.S. Supreme Court's 2005 decision in *Granholm v. Heald* to retailers. Originally filed in 2007, the *Siesta Village Market* case concerns Texas alcohol laws that prohibit out-of-state wine retailers from selling and shipping wine directly to Texas consumers, while allowing licensed Texas-based retailers to do so.

The Fifth Circuit ruled that the Twenty-first Amendment and the state's police powers over alcohol trump the dormant Commerce Clause of the U.S. Constitution when it comes to regulating the interstate sale and shipment of alcohol at the retail level, and in doing so joined the Second Circuit in breathing new life into the Twenty-first Amendment.

Those decisions, however, are argued by some observers as being in conflict the analysis recently utilized by the First Circuit in *California Family Winemakers v. Jenkins*. Just how deep a conflict there is between the circuits is open to debate. The arguments explored above suggest that harmonization of the First and Fifth Circuit decisions may be possible.

Whether the appellants in *Siesta Village Market* will get the chance to revisit the case and remake their arguments to the full Fifth Circuit remains unknown at this point. If the appellants' petition for En Banc review is granted and the case is reconsidered, a final decision by the entire Fifth Circuit is many months away.

As always, let me know if you have any questions or comments.