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## Three Cheers for Three Tiers: Why the Three-Tier System Maintains Its Legal Validity and Social Benefits After Granholm

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## **Three Cheers for Three Tiers: Why the Three-Tier System Maintains Its Legal Validity and Social Benefits After *Granholm***

*Roni A. Elias\**

### INTRODUCTION

Alcohol consumption has the potential to be either a great benefit or a great detriment to the United States economy. The direct retail sales of beer, wine and spirits at licensed establishments creates over 1.7 million jobs throughout the United States; and these direct retail sales create an more than 750,000 additional jobs in ancillary enterprises, such as suppliers.<sup>1</sup> In 2014, all of these enterprises together were responsible for as much as \$245 billion in total economic activity throughout the nation.<sup>2</sup> The business entities involved in the sale of alcohol, along with their employees, pay over \$19.3 billion in federal taxes, and \$16.9 billion in state and local taxes.<sup>3</sup>

At the same time, the excessive consumption of alcohol is both a public health problem and a source of grave economic loss. Alcohol abuse can lead to declining productivity in the workplace, increased illness and associated health care expenses, criminal justice expenses, and property damages, especially damages to motor vehicles involved in alcohol related accidents.<sup>4</sup> The Center for Disease Control and

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\* Roni A. Elias, continues his work *In Re BCCI* in which he has assisted in the return of over \$9 Billion to the depositors. J.D. FAMU, College of Law & B.S. NSU. I am so blessed & greatly appreciate the love of my life, M.G.S, for her love and making me smile every minute of every day. To Dr.'s Aida & Adil Elias, my first great teachers in life, I thank you and appreciate more than words can ever say. I am truly grateful to the best brother anyone could be blessed to have, my brother, Pierre A. Elias. To the *DePaul Business and Commercial Law Journal*, for their non-stop attention to detail I appreciate and thank.

1. *ABL Releases New Economic Impact Study; Reflects Positive Impact of Beverage Licensees*, AMERICAN BEVERAGE LICENSEES, (November 14, 2014), <http://ablusa.org/2014/11/abl-releases-new-economic-impact-study-reflects-positive-impact-of-beverage-licensees/>.

2. *Id.*

3. *Id.*

4. *Prevention, Excessive Drinking Costs U.S. \$223.5 Billion*, CENTER FOR DISEASE CONTROL AND PREVENTION, <http://www.cdc.gov/features/alcoholconsumption/> (last updated Apr. 17, 2014).

Prevention estimates that, in 2010, such problems caused economic losses totaling \$249 billion across the entire U.S. economy.<sup>5</sup>

Since the ratification of the Twenty-First Amendment in 1933, which ended Prohibition, the United States has employed a system for the distribution and retail sale of alcohol that has helped maximize the social benefits of alcohol use and minimize its dangers social costs. In this “three-tier” system, the producers of alcoholic beverages sell their products only to state-licensed distributors, who are the exclusive source for state-licensed retail outlets, including both liquor stores and bars and restaurants.<sup>6</sup> State-laws generally prohibit or greatly restrict the direct sale of alcohol from producers to consumers.<sup>7</sup>

The three-tier system promotes the effective regulation of consumption because the regulations are made at the state level and therefore can be responsive to local concerns and unique local circumstances.<sup>8</sup> The system also promotes economic efficiency by helping producers receive accurate information about consumer demand. Given their unique – and exclusive – position between consumers and producers, distributors have the informational and economic ability to make sure that products are directed to retail outlets with the greatest demand at a low cost.<sup>9</sup>

Since its inception in the wake of Prohibition, the three-tier system, including its ban on direct sales to consumers, was understood to be an exercise of state power conferred by the Twenty-First Amendment.<sup>10</sup> In 2005, in *Granholm v. Heald*, the United States Supreme Court invoked the dormant Commerce Clause to rule that states could not use the ban on direct sales to consumers as an instrument for discriminating against products from other states.<sup>11</sup> Thus, the Court imposed a limitation on states’ ability to use the structure of the three-tier system to regulate sales; but *Granholm* also re-affirmed the general validity of the three-tier system,<sup>12</sup> and left some uncertainty

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5. *Fact Sheets - Alcohol Use & Your Health*, CENTERS FOR DISEASE CONTROL AND PREVENTION, <http://www.cdc.gov/alcohol/fact-sheets/alcohol-use.htm> (last updated Feb. 4, 2016).

6. See *Granholm v. Heald*, 544 U.S. 460, 489 (2005) (discussing the “three-tier” system of regulating the sale of alcoholic beverages at the state level).

7. See generally, Kevin C. Quigley, *Uncorking Granholm: Extending the Nondiscrimination Principle to All Interstate Commerce in Wine*, 52 B.C. L. REV. 1871, 1877-78 (2011) (discussing the current limits on the direct shipment of wine from producers to consumers).

8. See *infra* § II.A.

9. See *infra* § II.B.

10. See *State Bd. of Equalization of Cal. v. Young’s Market, Co.*, 299 U.S. 59, 64 (1936) (discussing the scope of state power to regulate alcohol sales under the Twenty-First Amendment).

11. *Granholm*, 544 U.S. at 473.

12. *Id.* at 489.

about when and how states could continue to use a ban on direct sales as an element of that system.

Since *Granholm*, federal courts have upheld state-law restrictions on direct shipment, and the three-tier system has survived and even thrived. Its ability to promote economic efficiency and to serve as a framework for effective regulation has benefitted consumers, producers and society as a whole. While the Court's ruling in *Granholm* prohibited the use of regulations under the three-tier system as a means of discrimination against producers or products based on their location, that ruling and numerous judicial opinions following it have affirmed that the three-tier system is a legitimate instrument by which state governments may regulate alcohol sales.<sup>13</sup>

This paper argues that the three-tier system is not only a legitimate means of regulating alcohol sales but also a beneficial one that should be maintained. It begins this argument in Part I by describing the basic characteristics of the three-tier system. In Part II, it reviews how the three-tier system was developed after over a century of largely failed attempts to effectively regulate alcohol sales, and it explains how that system provides significant regulatory and economic advantages. Part III discusses how the expansion of direct shipment from suppliers to consumers and retailers threatens many of the benefits conferred by the three-tier system. Finally, Part IV reviews the *Granholm* decision and subsequent judicial rulings to see whether and to what extent the three-tier system can be maintained in a manner consistent with constitutional law.

## I. THE NATURE OF THE THREE-TIER SYSTEM

Many industries are built around a three-part structure that includes producers, wholesalers, and retailers. The business of selling alcoholic beverages is no exception. The wine and spirits industry has three main elements: (1) product manufacturers, (2) wholesale-distributors and (3) product retailers.<sup>14</sup> In most parts of the U.S., wine and spirits are distributed through these three segments, and this method of distribution is collectively referred to as the three-tier system.<sup>15</sup>

One of the chief objectives of the system is to rationalize and streamline the distribution of the incredibly wide variety of products available to consumers. In the first tier of the system, the producers of

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13. *Id.* at 493.

14. Davis S. Sibley & Padmanabhan Srinagesh, *Dispelling the Myths of the Three-Tier Distribution System* WINE AND SPIRIT WHOLESALERS OF AMERICA 6 (2008), [http://www.five-star-wine-and-spirits.com/includes/archivos/about\\_five\\_start/pdf/three\\_tier\\_01.pdf](http://www.five-star-wine-and-spirits.com/includes/archivos/about_five_start/pdf/three_tier_01.pdf).

15. *Id.*

alcoholic beverages bottle a wide range of products, many of which are targeted at narrow market niches. For example, there are literally hundreds of thousands of different types of wine available to consumers; *Wine Spectator* magazine offers reviews of 332,000 different wines.<sup>16</sup> Similarly, one website that lists popular brands of tequila identifies 89 different tequila products, ranging in price from under \$20 to over \$90.<sup>17</sup> In fact, the number of distilleries that produce all kinds of spirits are increasing dramatically. According to the American Craft Spirits Association, the number of local, craft distilleries in the United States increased from about 50 in 2005 to 769 in 2015.<sup>18</sup> And, of course, the recent growth of craft breweries is well-known; the volume of production from craft breweries, many of which serve only local or regional markets, almost doubled between 2006 and 2012.<sup>19</sup>

Producers sell this plethora of brands and products to wine and spirits wholesale distributors, who, in turn, resell those products retailers.<sup>20</sup> Wholesalers are not merely brokers or agents who work on a commission basis. Rather, wine and spirits wholesalers are merchant wholesalers who purchase goods on their own account for resale. Merchant wholesalers earn profits on commercially successful products and incur losses on failed products.<sup>21</sup> Wholesale distributors are licensed by state governments, and there are distributors of all sizes. According to one study completed in 2008, there were approximately 16,000 wholesaler licensees in the United States in 2008.<sup>22</sup>

Because so many of these products have specialized appeal, the wholesale distributors that make up the middle tier of the system do much more than serve as a passive conduit for products; they play an important role in identifying the local retail markets where unique products will have the most success. Because wholesalers serve a wide variety of retailers, they have an unparalleled opportunity to identify any common trends or differences among the retailers they serve

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16. See WINE SPECTATOR, WINE RATINGS, <http://www.winespectator.com/wineratings> (last visited November 28, 2015).

17. Colleen Graham, *A Guide to Popular Tequila Brands*, ABOUT FOOD (updated February 19, 2016), [http://cocktails.about.com/od/spirits/tp/tequila\\_brands.htm](http://cocktails.about.com/od/spirits/tp/tequila_brands.htm).

18. Chris Morris, *Craft Distilleries: The Next Local Liquor Boom?* FORTUNE (Aug. 1, 2015), <http://fortune.com/2015/08/01/distilleries-craft-beer-liquor/>.

19. 2012 *Small & Independent Craft Brewers' Growth in the Beer Category*, BREWERS ASSOCIATION, <http://www.craftbeer.com/wp-content/uploads/BrewStat.png> (last visited November 28, 2015) (showing that production at craft breweries increased from 7.1 million barrels in 2006 to 13.2 million in 2012).

20. Sibley & Srinagesh, *supra* note 14, at 14.

21. *Id.*

22. *Id.*

and?to convey their understanding of the marketplace to the suppliers they represent.<sup>23</sup> Thus, wholesalers collect and distribute important information that helps both retailers and producers respond more efficiently to changing consumer preferences.<sup>24</sup>

Consequently, wholesale distributors play an important role in marketing. With respect to individual liquor products, the producer creates a consumer image, and the wholesaler communicates that image to the retailers with whom it contracts; and retailers then communicate that image to consumers.<sup>25</sup> Retail establishments form the third tier of the system. Such establishments include full service restaurants (those serving alcohol), bars, and retail stores that sell beer, wine, and liquor. According to recent Census data, there are nearly a quarter-million full service restaurants,<sup>26</sup> nearly 50,000 bars,<sup>27</sup> and about 33,000 liquor stores<sup>28</sup> in the United States. For many customers, retail outlets are not just a convenient source for wine and spirits, they are also a principal source of information about, and a place to sample, new products.<sup>29</sup>

The range of selections at retail outlets varies substantially. A typical bar or full-service restaurant offers consumers a few dozen wines and spirits.<sup>30</sup> Larger traditional retailers such as Knightsbridge Wines in Illinois and the Wine Club in California stock about 8,000 distinct items.<sup>31</sup> By contrast, a typical Costco Wholesale Corp. outlet sells 120 wine labels and 30 to 35 spirits labels at any one time, and approximately half of the labels change every year.<sup>32</sup>

Given the wide range of products in the market and the variation of products available at different retailers, consumers often rely on retail stores for product information. Knowledgeable staff, product demonstrations, such as tastings, and promotional displays are all available in the retail store, and they all help consumers decide products suit their

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23. *Id.* at 12.

24. *Id.*

25. *Id.*

26. UNITED STATES CENSUS BUREAU, 2012 ECONOMIC CENSUS OF THE UNITED STATES: ACCOMMODATION AND FOOD SERVICES: PRELIMINARY SUMMARY STATISTICS FOR THE UNITED STATES, 2012, [http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN\\_2012\\_US\\_72I1&prodType=table](http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN_2012_US_72I1&prodType=table) (last visited March 20, 2016).

27. UNITED STATES CENSUS BUREAU, 2012 ECONOMIC CENSUS OF THE UNITED STATES: RETAIL TRADE: PRELIMINARY SUMMARY STATISTICS FOR THE UNITED STATES, 2012, [http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN\\_2012\\_US\\_44I1&prodType=table](http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN_2012_US_44I1&prodType=table) (last visited March 20, 2016).

28. *Id.*

29. Sibley & Srinagesh, *supra* note 14, at 12.

30. *Id.*

31. *Id.*

32. *Id.*

tastes.<sup>33</sup> Much of this information comes from wholesale distributors who educate the staff of retail stores, pay for the promotional displays, and furnish products for tastings.<sup>34</sup> The costs to wholesalers for providing marketing support to retailers are extensive, sometimes running in excess of \$10 million annually for large, regional distributors.<sup>35</sup>

## II. THE ORIGINS AND POLICY REASONS FOR THE THREE-TIER SYSTEM

### A. *Origins*

In historical terms, the three-tier system is a product of attempts at reforming the regulation of alcohol sales around the time of the Twenty-First Amendment, which ended Prohibition. When it became apparent that Prohibition was not going to succeed in solving the social and public health problems associated with abusive alcohol consumption, government officials and policy activists sought another way, that their efforts resulted in the three-tier system. Consequently, the three-tier system is, to a great extent, a response to failed efforts at alcohol regulation that preceded it, and understanding its effects, particularly in the regulatory context, requires some understanding of its background and origins.

From the colonial period through the end of the nineteenth century, Americans were concerned with controlling excessive and abusive alcohol consumption, but the patchwork of conflicting state laws directed towards this end was not especially effective. States experimented with various statutes that limited opportunities to purchase alcohol, and many states entirely prohibited the purchase and sale (but not necessarily the production) of alcohol.<sup>36</sup> Nevertheless, the problems associated with alcohol abuse continued to proliferate into the early twentieth century, as alcohol consumption increased by as much as 33 percent in the first decade of the twentieth century and the death rate from cirrhosis of the liver and chronic alcoholism reached high levels.<sup>37</sup>

Concern with this worsening problem led to federal legislation. In an effort to protect states that had chosen to completely ban alcohol,

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33. *Id.*

34. *Id.*

35. Sibley & Srinagesh, *supra* note 14, at 20.

36. See RUSSELL BLAINE NYE, *SOCIETY & CULTURE IN AMERICA, 1830-1860* 48-50 (1974); RONALD G. WALTERS, *AMERICAN REFORMERS 1815-1860* 135-37 (1978).

37. Jack S. Blocker, Jr., *Did Prohibition Really Work? Alcohol Prohibition as a Public Health Innovation*, 96 *AM. J. PUB. HEALTH* 233, 236 (2006).

Congress enacted the Webb–Kenyon Act in 1913.<sup>38</sup> It prohibited the interstate transportation of any form of alcohol into a state where that form of alcohol was illegal.<sup>39</sup> The Supreme Court affirmed the constitutionality of the Webb-Kenyon Act in *James Clark Distilling Co. v. Western Maryland Railroad Co.*, reasoning that the only purpose for the legislation “was to give effect to state prohibition” laws.<sup>40</sup> The Court made it clear that Webb-Kenyon did not give states the power to authorize the sale of liquor generally and to treat out-of-state liquor on unequal, discriminatory terms.<sup>41</sup> Thus, the Court held that, under the constitutional framework in place before Prohibition, states could regulate alcohol any way they chose, but the Commerce Clause prevented states from enacting any regulation that discriminated on the basis of where alcohol was produced.<sup>42</sup>

The political momentum that helped to support the Webb-Kenyon Act soon resulted in the Eighteenth Amendment, which prohibited “the manufacture, sale, or transportation of intoxicating liquors” within the United States, and the import or export of intoxicating liquors to or from the United States.<sup>43</sup> But the total prohibition on all commerce in alcoholic beverages seemed to generate more problems than it solved. Although alcohol consumption declined and abstinence increased during Prohibition,<sup>44</sup> compliance with the ban on alcohol sales was anything but uniform, especially because there were many Americans who consumed alcohol moderately and responsibly and thought that a total ban on alcohol sales was an unwarranted means to curb abusive consumption. In addition, most Americans thought that Prohibition helped to increase lawlessness and the growth of organized crime.<sup>45</sup> Consequently, public support for Prohibition waned quickly, and many Americans began to try to formulate a way to regulate alcohol use that was short of an outright ban but

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38. See 27 U.S.C. § 122 (2015).

39. *Id.*

40. *James Clark Distilling Co. v. Western Maryland Railroad Co.*, 242 U.S. 311, 337 (1917).

41. *Id.* at 324.

42. See *id.*; see also Quigley, *supra* note 7, at 1877.

43. U.S. CONST. amend. XVIII, § 1. It is worth noting that the Eighteenth Amendment did not outlaw the consumption of alcoholic beverages.

44. Jeffrey A. Miron & Jeffrey Zwiebel, *Alcohol Consumption During Prohibition*, 81 AM. ECON. REV. 242, 244–247 (1991); Blocker, *supra* note 37, at 237.

45. Blocker, *supra* note 37, at 237; see also ANDREW SINCLAIR, *PROHIBITION: THE ERA OF EXCESS* 211–212, 220–230 (1962).

that would also be effective in avoiding the problems of abuse that had helped prompt Prohibition.<sup>46</sup>

There were varying proposals for reforming the regulation of alcohol sales. Some, led by John D. Rockefeller, called for a government monopoly on the production and consumption of all alcoholic beverages.<sup>47</sup> Although this particular policy prescription was not uniformly adopted, eighteen states eventually followed a version of it by creating a government monopoly on distribution and, in some cases, permitting retail sales of packaged liquor only in government-owned outlets.<sup>48</sup> Today, seventeen states employ some variation of this regulatory system, although these state retail monopolies tend to focus on liquors with relatively high alcoholic content.<sup>49</sup>

The most widely adopted proposal for regulating alcohol sales and use was what is now known as the three-tier system. In general, this system was designed to discourage drinking in bars and saloons and encourage it in restaurants and above all, at home.<sup>50</sup> The right to sell alcohol was subject to licenses issued by a commission that operated as an agency of state government.<sup>51</sup> Retail sales were permitted only in restaurants, bars, and stores that were licensed by the state commission, and there were different categories of licenses for beer and wine, on the one hand, and distilled spirits, on the other.<sup>52</sup> When it came to issuing licenses authorizing on-premises consumption, state commissions tended to favor establishments where food was served.<sup>53</sup> Retail sales were permitted only in restaurants, bars, and stores that were licensed by the state commission, and there were different categories of licenses for beer and wine, on the one hand, and distilled spirits, on the other.<sup>54</sup> When it came to issuing licenses authorizing on-premises consumption, state commissions tended to favor establishments where food was served.<sup>55</sup> The scheme also limited whom retailers could purchase from. In general, direct purchasing from producers was out-

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46. HARRY G. LEVINE & CRAIG REINARMAN, ALCOHOL PROHIBITION AND DRUG PROHIBITION: LESSONS FROM ALCOHOL POLICY FOR DRUG POLICY *in* DRUGS AND SOCIETY: U.S. PUBLIC POLICY 59 (Jefferson M. Fish, ed., 2006).

47. *Id.* at 59.

48. *State Control of Alcohol: Protecting the Public's Health*, ALCOHOL JUSTICE, [https://alcoholjustice.org/images/fa\\_ctsheets/StateControlPublicHealth2014.pdf](https://alcoholjustice.org/images/fa_ctsheets/StateControlPublicHealth2014.pdf) (last visited Nov. 29, 2015).

49. *Id.*

50. Blocker, *supra* note 37, at 239.

51. LEVINE & REINARMAN, *supra* note 46, at 56-57.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

lawed, and retailers could purchase only from wholesalers who were also licensed by the state commission.<sup>56</sup>

Once it was possible to imagine an effective regulatory regime, such as the three-tier system, the repeal of Prohibition seemed more feasible. Consequently, on December 5, 1933, the Twenty-first Amendment was ratified.<sup>57</sup> Section 1 of the amendment repealed the Eighteenth Amendment.<sup>58</sup> Section 2 provided that “[t]he 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.”<sup>59</sup> Since its ratification, the meaning of Section 2 has been a matter of uncertainty and conflict within the federal judiciary.<sup>60</sup> According to one view, Section 2 created new authority for state governments to regulate alcohol, unfettered by the Commerce Clause.<sup>61</sup> According to an opposing view, Section 2 only gave states plenary authority to regulate alcohol within their borders, and it did not give states any authority to enact laws that would have a restrictive or discriminatory effect in interstate commerce.<sup>62</sup>

This uncertainty about the legal significance of Section 2 of the Twenty-First Amendment has created questions about the extent to which states can use the three-tier system to prohibit the direct shipment of alcohol from producers to consumers. This uncertainty in turn creates a question about the preservation of the entire system because the system can continue to function only if there are essentially exclusive relationships between producers and wholesale distributors and between wholesalers and retailers. And the three-tier system provides an essential framework for the business of selling alcoholic beverages. As its history shows, it was created for a purely regulatory purpose, and, over eighty years of practical experience, it is clear that the system serves that purpose well. In addition, recent economic analyses

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56. *Id.*

57. U.S. CONST., amend. XXI.

58. U.S. CONST., amend. XXI, § 1.

59. U.S. CONST., amend. XXI, § 2.

60. *Compare* *Ziffrin, Inc. v. Reeves*, 308 U.S. 132, 138 (1939) (“The Twenty-first Amendment sanctions the right of a state to legislate concerning intoxicating liquors brought from without, unfettered by the Commerce Clause.”) *and* *United States v. Frankfort Distilleries*, 324 U.S. 293, 299 (1945) (holding that granting states full authority to regulate alcohol within their borders does not give them “plenary and exclusive power to regulate the conduct of persons doing an interstate liquor business outside their boundaries”).

61. *See Ziffrin*, 308 U.S. at 138; *see also State Bd. of Equalization v. Young’s Market, Co.*, 299 U.S. 59, 64 (1936).

62. *See Frankfort Distilleries*, 324 U.S. at 299; *see also Granholm v. Heald*, 544 U.S. 460, 473 (2005).

have shown that the system provides important economic benefits that enhance the salutary economic effect of alcoholic beverages.

### B. *Regulatory Advantages*

Given the dangers associated with alcohol abuse, the effective regulation of alcohol sales is of paramount importance. As one commentator has noted, alcohol is “no ordinary commodity,”<sup>63</sup> and, therefore, extra care must be taken in regulating it. According to the Centers for Disease Control and Prevention (“CDC”), excessive alcohol use can lead to a variety of serious, chronic diseases including high blood pressure, heart disease, stroke, liver disease, digestive problems, several types of cancer, learning and memory problems, mental health problems (such as depression and anxiety), social problems (such as lost productivity, family problems, and unemployment), and, of course, alcohol dependence, or alcoholism.<sup>64</sup> These problems are certainly keenly felt across all segments of American society. As the CDC points out:

Excessive alcohol use led to approximately 88,000 deaths and 2.5 million years of potential life lost (YPLL) each year in the United States from 2006 – 2010, shortening the lives of those who died by an average of 30 years. Further, excessive drinking was responsible for 1 in 10 deaths among working-age adults aged 20-64 years. The economic costs of excessive alcohol consumption in 2010 were estimated at \$249 billion, or \$2.05 a drink.<sup>65</sup>

When the locus of regulation is at the state level, the regulatory authority can tailor its rules to local conditions. For example, a state government could establish a procedure by which local communities could set their own rules for alcohol sales, even to the point that they would prohibit alcohol sales altogether within their area.<sup>66</sup> As one Congressman has noted, “an effective tool of local neighborhoods in Chicago has been the ability to vote, through ballot referendum, an area ‘dry.’”<sup>67</sup> Thus, the three-tier system provides an unmatched ability to empower local communities. If the regulatory authority is centralized at a federal level, or if direct sales via the Internet effectively deprive state and local authorities of their ability to regulate sales, these kinds of locally-oriented regulations would disappear.

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63. THOMAS BABOR ET AL., *ALCOHOL: NO ORDINARY COMMODITY* (2003).

64. *Alcohol Use & Your Health*, *supra* note 5.

65. *Id.* (internal citations omitted).

66. *Legal Issues Concerning State Alcohol Regulation: Hearing Before the H. Subcomm. on Courts and Competition Policy of the Comm. on the Judiciary*, 111th Cong. 145 (2010) (statement of Rep. Rush, Member, H. Subcomm. on Courts and Competition Policy).

67. *Id.*

One aspect of the local tailoring of regulations is the capacity to make a quick response to new developments and problems. For example, in 2011, the Nebraska Liquor Control Commission learned of “rampant alcohol abuse and bootlegging” in a town of about two dozen residents on the Pine Ridge Indian Reservation in a remote area of the state’s panhandle.<sup>68</sup> Commission officials acted to restrict the hours during which alcohol sales can be made in the town and surrounding area and to take other remedial measures designed to specifically respond to unique local conditions.<sup>69</sup> Similarly, in Washington state, the Liquor Control Board has taken information about alcohol products that are abused in particular local areas, and it has taken special measures to restrict their availability in those localities.<sup>70</sup>

Another significant regulatory advantages of the three-tier system is that it permits effective enforcement. As noted by Nida Samona, the Chairperson of the Michigan Liquor Control Commission, the physical proximity of commission staff and local law enforcement to retailers and wholesalers ensures “that in-state retailers and wholesalers are physically inspected and checked to verify that [the] regulatory system is being followed, that only approved alcoholic beverages are being sold, that alcoholic beverages are not being sold to underage persons, and that taxes are being paid.”<sup>71</sup> This oversight gives states “the ability and that power to bring [noncompliant] licensees in, to suspend them for a few days. . . ., to take away the license, to go onsite. . . .,” either through state officials or local police.<sup>72</sup>

Ultimately, the decentralized regulatory regime enabled by the three-tier system makes producers, wholesalers, and retailers alike accountable to local communities. As a policy expert recently observed, “[a]s this industry becomes more and more consolidated, more and more globalized, it is critical to be able to regulate as much as we can at the local level. And not just retailers, but wholesalers,” are instrumental to this project.<sup>73</sup> Indeed, private actors at each of the three

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68. Grant Schulte, *Nebraska Lawmakers Mull Alcohol Problems in Whiteclay*, News from Indian Country (Oct. 2011), <http://www.indiancountrynews.com/index.php/news/9-news-from-through-out-indian-country/12063-nebraska-lawmakers-mull-alcohol-problems-in-whiteclay> (last visited Nov. 29, 2015).

69. *Id.*

70. *Id.*

71. *Legal Issues Concerning State Alcohol Regulation*, *supra* note 64, at 43 (statement of Nida Samona, Chairperson, Michigan Liquor Control Commission).

72. *Id.* at 145.

73. *Comprehensive Alcohol Regulatory Effectiveness (CARE) Act of 2010: Hearing on H.R. 5034 Before the H. Comm. on the Judiciary*, 111th Cong. 159 (2010) (statement of Michele Simon, Research and Policy Director, Marin Institute), [http://judiciary.house.gov/\\_files/hearings/pdf/Simon100929.pdf](http://judiciary.house.gov/_files/hearings/pdf/Simon100929.pdf) (last visited Nov. 29, 2015).

tiers have significant incentives to assure that their business partners in the other tiers adhere to regulations.<sup>74</sup> For example, a wholesaler has an interest in encouraging the retailers with whom they do business to comply with applicable regulations, and the wholesaler also has the day-to-day contact with retailers that would enable them to identify and address any compliance problems.

All of these aspects of the regulatory regime associated with the three-tier system show that it remains well-suited to addressing the policy considerations that inspired its adoption in so many states after the repeal of Prohibition in 1933. The three-tier system provides a flexible regulatory structure that can be readily tailored to local conditions, which assures that its rules will be more likely to find public acceptance as well as to effectively promote the safer consumption and sale of alcohol. Moreover, even though these regulatory considerations are of paramount importance, they are not the only reasons why the three-tier system is an especially effective means of organizing the sale of alcoholic beverages.

### C. *Economic Advantages*

Although it was originally designed with a purely regulatory purpose, the three-tier system has proven to serve important economic objectives as well. Given the enormous – if not overwhelming – variety of alcoholic beverage products, and given the variation in consumer demand across different geographic areas, the marketing of those products to consumers is a difficult and complicated process. For one thing, it is virtually impossible for an individual consumer to be educated about the thousands of different products that he or she might purchase. The three-tier system provides an invaluable instrument for conveying information and reducing transaction costs within the alcoholic beverage industry.

Until recently, there have been few analyses of the economic impact of the three-tier system. But in a 2008 study, David S. Sibley and Padmanabhan Srinagesh provide a sophisticated analysis of the economics of the three-tier system, drawing on economic data from firms in the system, other econometric data, and interviews with major players in wholesale distribution and retail sales.<sup>75</sup> This study and other related scholarship and data provide insight into how the three-tier

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74. *Legal Issues Concerning State Alcohol Regulation* *supra*, note 64, at 45 (statement of Nida Samona, then-Chairperson, Michigan Liquor Control Commission).

75. Sibley & Srinagesh, note 14.

system improves the economic efficiency of the alcoholic beverage industry as a whole.

One of the principal ways that the three-tier system produces economic efficiency is to reduce transaction costs across all segments of the industry. Given the extraordinary variety of products that suppliers deliver to one end of the market, and given the equally broad variety of demand across all consumers at the other end of the market, it is possible, in theory, for significant inefficiencies caused by a large number of transactions. For example, consider a consumer who likes to drink Budweiser beer, a brand of tequila produced by a boutique distillery, and a few specific varieties of wine. Such a consumer might visit his local liquor store on a weekly basis, usually buying beer, and purchasing his favorite wine products somewhat less frequently, and his favorite tequila only a few times a year. If that local liquor store wants to assure that it is his first choice for all of his purchases, it will have to keep all of those products in stock, but the cost of maintaining inventory for this kind of complex purchasing behavior can be very high, especially when the store has dozens or even hundreds of customers who each have their own unique preferences and purchasing patterns. Juggling the purchase of so many different products from many different suppliers in varying amounts can be difficult for any retailer.

The three-tier system streamlines this process and reduces the transaction costs because wholesale distributors can serve a crucial intermediary function. Wholesalers can match the different needs of suppliers and retailers “by maintaining inventories in their warehouses and operating transportation fleets to deliver wine and spirits to retail outlets in a timely manner.”<sup>76</sup> This is so because wholesalers have the capacity to routinely deliver individual bottles or split cases (cases customized with various individual bottles) to stores, bars, and restaurants, usually in a turnaround period of a day or two.<sup>77</sup> The presence of wholesalers as intermediaries means that suppliers can sell large volumes of products in a relatively small number of transactions and that retailers can customize their ordering to meet the diverse demands of their customers without incurring the cost of maintaining a large inventory.<sup>78</sup> The service that wholesalers provide in the business of selling alcoholic beverages makes it possible to funnel the wide

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76. *Id.* at 14.

77. *Id.*

78. *Id.*

variety of available products to different market niches with efficiency that would not be available in a marketplace without wholesalers.<sup>79</sup>

These efficiencies become more important as computer-based technology plays an ever-increasing role in inventory management. Because the sale of alcoholic beverages is so heavily regulated, because those regulations vary so widely between jurisdictions and among particular categories of beverages, and because there are so many different products, it is increasingly important for wholesalers to employ computer-based information management systems.<sup>80</sup> “These information systems help ensure that complex shipments, payments and taxes are accurately tracked and that state and federal regulations are met.”<sup>81</sup> It would not make much sense for suppliers to maintain such systems because their nationwide market would require a prohibitively large and complex system that would be unwieldy to use. By the same token, individual suppliers lack the sales and inventory volume that would make such systems efficient for them. Thus, wholesalers who operate on a regional level are best positioned to employ such system with the most favorable ratio of benefits to cost.<sup>82</sup>

In addition, wholesalers have a unique capacity to reduce the cost of maintaining such computer systems. These systems often have to synchronize data with multiple sources. Consequently, such systems must be able to accommodate the wide variety hardware and software that is already installed at these multiple sources.<sup>83</sup> By reducing the number of parties that need to transact directly with one another, the business structure of the three-tier system “reduces the number of different computer systems that need to communicate directly with one another, permitting greater interoperability of information systems used in the wine and spirits industry and further reducing the costs of distribution while increasing the range of services provided.”<sup>84</sup>

In short, the three-tier system provides opportunities for creating economies of scale that simply would not exist in a world where suppliers shipped directly to retailers or even to consumers. Sibley and Srinagesh estimate that “wholesaler activities reduce retailers’ costs by almost \$52.00 for every \$1,000.00 in retailer sales, for a national savings in retailer operating costs of \$7.2 billion per year.”<sup>85</sup> These

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79. *Id.* at 14-15.

80. *Id.*

81. Sibley & Srinagesh, *supra* note 14, at 15.

82. *Id.*

83. *Id.* at 27.

84. *Id.*

85. *Id.* at 14 (citing JOHN DUNHAM, THE ECONOMIC VALUE OF WINE AND SPIRITS WHOLESALEERS (2008)).

wholesaler-created economies of scale make it possible for consumers to purchase at lower prices, which means that they have more disposable income to spend on a wider variety of products of all kinds.

Given their position between retailers and suppliers, wholesalers have a unique opportunity to acquire and disseminate the flow of information necessary for effective marketing. “Because wine and spirits are experience goods and highly influenced by marketing activities, distributors’ knowledge of consumers’ purchasing habits can be critical to the whole industry.”<sup>86</sup> Wholesalers have comprehensive information about both the range of products available from suppliers and the particular market characteristics within their regions, they have an unparalleled ability to identify the best ways to promote products and the best areas or market niches in which to promote them.<sup>87</sup> This information comes, at least in part, from their maintenance of the kinds of computer systems described above, which give them the capacity to aggregate sales data and identify market trends in a way that suppliers and retailers cannot.<sup>88</sup>

The economics of selling alcoholic beverages make this kind of marketing expertise especially important. When a supplier introduces a new product, it will generate little profit at first because its promotional costs will be high and it can be difficult to convince retailers to provide shelf space for it.<sup>89</sup> Indeed, the inventory holding costs associated with new brand introduction can exceed \$1 million.<sup>90</sup> Wholesalers can reduce the promotional and inventory costs for new products by making sure that promotions are targeted accurately and by maintaining inventory that retailers might not be ready to maintain themselves.<sup>91</sup>

The economic structure of the three-tier system also promotes efficient outcomes by facilitating a certain degree of vertical integration and the maintenance of minimum prices. At first blush, such things might seem to be anti-competitive. But some recent economic studies suggest that, under the right circumstances, they can have pro-competitive effects.<sup>92</sup> And the United States Supreme Court has recognized that a degree of vertical integration and price floors are not necessarily violations of antitrust law.<sup>93</sup>

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86. *Id.* at 18.

87. Sibley & Srinagesh, *supra* note 14, at 18

88. *Id.*

89. *Id.* at 20.

90. *Id.*

91. *Id.*

92. *Id.* at 32-35.

93. *See* *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

Economists have recognized that, under certain conditions, restricting competition through the use of exclusive territories can solve fundamental business problems.<sup>94</sup> For example, when marketing requires a distributor to undertake certain activities that are difficult to specify, monitor and measure, it may be difficult or impossible to regulate the distributor's compliance by contract. "By giving the distributor an exclusive territory and some protection from intrabrand competition, however, the supplier creates a financial incentive for the distributor to undertake the required marketing investments necessary to compete against brands represented by other wholesalers (interbrand competition)."<sup>95</sup>

In its decision in *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, the United States Supreme Court has also recognized that the creation of exclusive territories and minimum retail prices can actually promote competition rather than hinder it.<sup>96</sup> When a supplier has an exclusive agreement with a distributor, and when that agreement includes prescriptions about a minimum price for a product, such arrangements can reduce intrabrand competition and stimulate the distributor's marketing efforts.<sup>97</sup> This is because, in a territory where a distributor has exclusive rights in a particular brand, that distributor does not compete with any other provider of that brand in its territory, but it does have an incentive to invest in its brand in order to compete vigorously against distributors of competing brands.<sup>98</sup> Establishing a minimum price helps control the free-riding incentive, and each distributor competes with other distributors by adding value to its product.<sup>99</sup> As the *Leegin* Court explained:

The justifications for vertical price restraints are similar to those for other vertical restraints. . . . Minimum resale price maintenance can stimulate interbrand competition—the competition among manufacturers selling different brands of the same type of product—by reducing intrabrand competition—the competition among retailers selling the same brand. . . . The promotion of interbrand competition is important because “the primary purpose of the antitrust laws is to protect [this type of] competition.” . . . A single manufacturer's use of vertical price restraints tends to eliminate intrabrand price competition; this in turn encourages retailers to invest in tangible or intangible services or promotional efforts that aid the manufac-

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94. See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 418-24 (4th ed. 2005).

95. Sibley & Srinagesh, *supra* note 14, at 32.

96. *Leegin*, *supra* note 90, at 890.

97. Sibley & Srinagesh, *supra* note 14, at 33 (discussing *Leegin*).

98. *Id.*

99. *Id.*

turer's position as against rival manufacturers. Resale price maintenance also has the potential to give consumers more options so that they can choose among low-price, low-service brands; high-price, high-service brands; and brands that fall in between.<sup>100</sup>

The sale of alcoholic beverages within the structure of the three-tier system provides exactly the right kind of opportunity to promote the pro-competitive effects described in *Leegin*. One study of beer sales in Indiana confirms this conclusion. It found that the prohibition of exclusive territories for beer sales actually caused a decrease in beer sales.<sup>101</sup>

### III. THE THREAT TO THE THREE-TIER SYSTEM POSED BY DIRECT SHIPMENT

One of the biggest challenges to the preservation of the three-tier system has been the recent proliferation of small-scale producers of beer, wine, and spirits, who seek to use the Internet as a means to sell directly to retailers and consumers. Some, including the Federal Trade Commission, have suggested that these developments warranted a significant reconsideration of how the market for alcoholic beverages should be structured.<sup>102</sup> These suggestions often overlook the unique nature of this market and have generally overstated the economic benefits that would come from expanding the scope of direct shipment.

The recent expansion of small-scale production of alcoholic beverages has been dramatic. For example, the proportion of American wine produced by small, family farm wineries has increased dramatically in the last thirty years.<sup>103</sup> According to some estimates, there are now nearly 3000 such wineries, in the United States, double the number that existed in the late 1970s.<sup>104</sup> There have been similar increases in the number of small-scale craft breweries and distilleries.<sup>105</sup>

Given their small size, these boutique suppliers cannot furnish enough products to meet the volume requirements of distributors in

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100. *Leegin*, *supra* note 90, at 890 (internal citations omitted).

101. See Tim R. Sass & David S. Saurman, *Efficiency Effects of Exclusive Territories: Evidence from the Indiana Beer Market*, in 34 *ECON. INQUIRY* 597, 614 (1996).

102. FEDERAL TRADE COMMISSION, POSSIBLE ANTI-COMPETITIVE BARRIERS TO E-COMMERCE: WINE (2003) 41, [https://www.ftc.gov/sites/default/files/documents/advocacy\\_documents/ftc-staff-report-concerning-possible-anticompetitive-barriers-e-commerce-wine/winereport2.pdf](https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-report-concerning-possible-anticompetitive-barriers-e-commerce-wine/winereport2.pdf) (last visited Dec. 2, 2015).

103. Matthew B. Mills, *Let History Be Our Guide: Using Historical Analogies to Analyze State Response to a Post-Granholm Era*, 81 *IND. L.J.* 1097, 1110-11 (2006).

104. *Id.*

105. Morris, *supra* note 17; 2012 *Small & Independent Craft Brewers' Growth in the Beer Category*, *supra* note 18.

the three-tier system.<sup>106</sup> The only economically viable way for these smaller suppliers to reach consumers is to sell directly, either on their own premises or over the Internet.<sup>107</sup> This fact has inspired the conclusion that consumers will enjoy greater choice in products and lower prices if direct shipment is widely permitted.

In 2003, the FTC issued a staff report that attracted significant attention for expressing just such a conclusion. The report compared the prices of certain highly regarded wines at retail stores in McLean, Virginia and at on-line retailers who shipped directly to the consumer.<sup>108</sup> The report concluded that direct shipment could result in cost savings – provided the consumers ordered at least six bottles at a time and chose the right kind of shipping method.<sup>109</sup>

But the virtues of direct shipment are easily overstated.<sup>110</sup> To a great extent, the economic benefits of direct shipment, which were described in the FTC report, are available because of the role that wholesalers play in informing consumers about which brands to seek out from suppliers. With the expansion of direct shipment to both consumers and high-volume retailers, wholesalers will lose the economic advantages that permit them to engage in valuable marketing activities, and the entire market for wine – not to mention other alcoholic beverages – will look much different. As Sibley and Srinagesh explain:

When regulations permit large retailers to bypass the three-tier system, wholesalers will no longer have exclusive territories because suppliers will also be able to sell direct to big-box retailers, whose business models do not emphasize marketing investments in the specific brands they carry. Unwilling to shoulder the marketing alone, wholesale competitors are likely to refrain from brand-specific marketing activities, waiting instead for another wholesaler to invest in marketing and to undertake the efforts necessary to create or maintain customer demand for the product. Once another wholesaler performs these activities, the competitors who did not make comparable investments (including any big-box retailers) will benefit from the increased brand awareness and demand stimulated by others' marketing efforts, despite not having performed the activities themselves. Competitors who did not engage in marketing activities for the product can undersell the investors, essentially "free-riding" on the investment of their rivals.<sup>111</sup>

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106. Mills, *supra* note 100, at 1111.

107. FEDERAL TRADE COMMISSION, *supra* note 99, at 1.

108. *Id.* at Appendix A.

109. *Id.*

110. Sibley & Srinagesh, *supra* note 14, at 28.

111. *Id.* at 34.

Needless to say, a market characterized by skewed incentives and rampant free-riding will not produce efficient outcomes.

Increasing direct shipment is also likely to result in more economic power for large retail outlets at the expense of locally-owned retailers and even wholesalers. If the three-tier system is modified to permit more direct shipment, big-box stores will be positioned to purchase at discounted prices from large suppliers, while wholesalers and smaller-sized retailers lose sales and profits.<sup>112</sup> Consumers who shop for certain products at big-box retailers will benefit from lower prices on those products, but the market as a whole will have less variety, poorer information exchanges between consumers and suppliers, and less popular brands will likely increase in price and be sold in fewer outlets.<sup>113</sup>

Of course, more direct shipment to consumers and retailers will have deleterious effects on regulation as well. With respect to direct shipments from suppliers to consumer, any regulations about who can buy or about how much can be bought will be reduced to a kind of “honor system.” There will be no-one in position to assure that sales are being conducted in accordance with law.<sup>114</sup> In addition, direct shipment eliminates the opportunity to restrict sales by limiting the location and hours of operation for retail outlets, which have proven to be effective regulatory responses to increased rates of alcohol abuse or alcohol-related problems.<sup>115</sup> Even more generally, direct shipment undermines the regulatory regime in numerous problematic ways. As one state regulator pointed out in a testimony to Congress, the direct shipment of alcohol “undermines the ability of states to fully account for the sale of alcohol within their borders.”<sup>116</sup>

#### IV. GRANHOLM AND ITS EFFECT ON THREE-TIER SYSTEM

Despite the problems associated with direct shipment, not to mention the uncertainty of its economic benefits, the momentum towards removing legal obstacles to direct shipment has continued in the last decade. The most important event in this connection was the Su-

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112. *Id.* at 38.

113. *Id.*

114. *Legal Issues Concerning State Alcohol Regulation supra*, note 64, at 41-42.

115. R.A. Hahn, *et al.*, *The Effectiveness of Policies Maintaining or Restricting Days of Alcohol Sales on Excessive Alcohol Consumption and Related Harms*, 39 AM. J. PREV. MED. 575, 575 (2010); *see also* Schulte, *supra* note 65 (describing how state liquor control officials used restricted hours for sales to address a localized increase in the rate of alcohol abuse and alcohol-related crime).

116. *Hearing on H.R. 5034, supra* note 70, at 152.

preme Court's decision in *Granholm v. Heald*.<sup>117</sup> There, the Court ruled that the Commerce Clause prohibited states from regulating direct shipment in a manner that resulted in discrimination in favor of intrastate direct shipments and against interstate direct shipments.

The dispute in *Granholm* arose from attempts by Michigan and New York to regulate the direct shipment of wine from out-of-state suppliers to in-state consumers. Both New York and Michigan have three-tier regulatory systems for the sale of alcoholic beverages, and both states attempted to modify those systems by licensing in-state wineries to sell their products directly to consumers while not offering licenses to out-of-state wineries on the same terms.<sup>118</sup> In Michigan, out-of-state wineries could sell only to wholesalers licensed by the state.<sup>119</sup> In New York, out-of-state wineries could sell directly to New York consumers only if they opened a branch, factory, office, or store-room inside the state.<sup>120</sup>

A majority of the Supreme Court held that New York and Michigan violated the Commerce Clause through their methods of regulating direct shipment. By focusing on the Commerce Clause as the core of its analysis, the majority opinion made it clear that the problem with the states' laws was their discriminatory character, not their prohibition of direct shipment.

The rule prohibiting state discrimination against interstate commerce follows also from the principle that States should not be compelled to negotiate with each other regarding favored or disfavored status for their own citizens. States do not need, and may not attempt, to negotiate with other States regarding their mutual economic interests. Cf. U.S. Const., Art. I, § 10, cl. 3. Rivalries among the States are thus kept to a minimum, and a proliferation of trade zones is prevented. . . .

Laws of the type at issue in the instant cases contradict these principles. They deprive citizens of their right to have access to the markets of other States on equal terms. The perceived necessity for reciprocal sale privileges risks generating the trade rivalries and animosities, the alliances and exclusivity, that the Constitution and, in particular, the Commerce Clause were designed to avoid.<sup>121</sup>

In reaching the conclusion that the Commerce Clause controlled the states' ability to regulate alcohol sales, the *Granholm* majority rejected the idea that the ratification of the Twenty-First Amendment had enlarged the states' regulatory power. It held that:

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117. *Granholm v. Heald*, 544 U.S. 460 (2005).

118. *Id.* at 469-70.

119. *Id.* at 469.

120. *Id.* at 470.

121. *Id.* at 472-73.

The aim of the Twenty-first Amendment was to allow States to maintain an effective and uniform system for controlling liquor by regulating its transportation, importation, and use. The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time.<sup>122</sup>

Apparently ignoring the Court's focus on the discriminatory effect of the regulations, some commentators concluded that removing barriers to direct shipment could – or should – open the door to a nationwide market in the direct shipment of all kinds of alcoholic beverage products to consumers and retailers.<sup>123</sup> But the majority opinion in *Granholm* asserted unequivocally that the three-tier system was “‘unquestionably legitimate.’”<sup>124</sup> In addition, subsequent case law in the lower courts made it clear that the problem with the New York and Michigan laws in *Granholm* was the fact that they discriminated against interstate commerce, not that they imposed restrictions on direct shipment.

In one of the earliest post-*Granholm* decisions, *Brooks v. Vassar*, the Fourth Circuit considered a challenge by Virginia consumers and out-of-state wineries to the volume limits on personal importation, which were a part of Virginia's alcoholic beverage control law.<sup>125</sup> The Fourth Circuit's ruling focused on the plaintiffs' argument that Virginia discriminated against interstate commerce by limited direct sales from out-of-state wineries to consumers to a total of one gallon or four liters of wine.<sup>126</sup> In rejecting this argument, the appeals court pointed out that, after some recent amendments, Virginia's law required all in-state wineries to sell to Virginia customers only through the three-tier system, either through their own retail outlets, which had to be licensed within the system, or through wholesalers, who also were licensed within the system.<sup>127</sup> The Fourth Circuit found no “economic protectionism” in Virginia's regulatory scheme, and therefore concluded that it did not contradict the Commerce Clause principles that were at the core of *Granholm*.<sup>128</sup>

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122. *Id.* at 484-85.

123. See, e.g., Quigley, *supra* note 7, at 1905; Kristin Woeste, *Reds, Whites, and Roses: The Dormant Commerce Clause, the Twenty-First Amendment, and the Direct Shipment of Wine*, 72 U. CIN. L. REV. 1821, 1845-46 (2004).

124. *Granholm*, 544 U.S. at 489 (quoting *North Dakota v. United States*, 495 U.S. 423, 432 (1986)).

125. *Brooks v. Vassar*, 462 F.3d 341, 344-45 (4th Cir. 2006).

126. *Id.* at 352.

127. *Id.*

128. *Id.* at 352-54.

The Second Circuit also relied heavily on the concept of “economic protectionism” in its analysis of a similar challenge to New York regulations in *Arnold’s Wines, Inc. v. Boyle*.<sup>129</sup> There, the regulations at issue permitted an in-state alcoholic beverage retailer to deliver directly to consumers’ residences in New York, using the retailer’s own vehicles or by using vehicles of a transportation company licensed by the State’s liquor authority; but out-of-state retailers did not have the same permission.<sup>130</sup> The Second Circuit concluded that the New York law did not violate Commerce Clause prohibitions against discriminatory legislation because, under *Granholm*, the Commerce Clause only prohibits discrimination against out-of-state products and producers.<sup>131</sup> In this connection, the Second Circuit noted that, in any state, there are aspects of the three-tier system that are inherently discriminatory against out-of-state entities. For example, in many states, wholesalers and retailers must be physically present in the state in order to get a license. And there is no question that this kind of discrimination is part of the system that the *Granholm* Court identified as unquestionably legitimate.<sup>132</sup> Thus, the Second Circuit ruled that the New York regulations were not unconstitutional because they did not discriminate against out-of-state products or producers.<sup>133</sup>

In *Siesta Village Market, LLC v. Steen*, the Fifth Circuit confirmed that *Granholm* did not undermine the integrity of the three-tier system generally and that it only prohibited regulations within a system that created discrimination against interstate commerce.<sup>134</sup> This case arose from a challenge to several different Texas regulations by parties outside of Texas who wanted to make retail sales directly to Texas consumers. In particular, the case focused on rules that permitted an in-state retailer to deliver wine to consumers within the county in which the retailer was located but that prohibited out-of-state retailers from delivering wine to consumers in Texas.<sup>135</sup> The Fifth Circuit held that such rules passed constitutional muster because they did not discriminate against out-of-state products or producers and because a set of rules governing local distribution of any products within the state was a “benign incident of an acceptable three-tier system.”<sup>136</sup>

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129. *Arnold’s Wines, Inc. v. Boyle*, 571 F.3d 185 (2d Cir. 2009).

130. *Id.* at 188.

131. *Id.* at 191.

132. *Id.*

133. *Id.*

134. *Siesta Vill. Mkt., LLC v. Steen*, 595 F.3d 249 (5th Cir. 2010).

135. *Id.* at 260-61.

136. *Id.* at 260.

## CONCLUSION

Given the dramatic effects that e-commerce and Internet marketing have had on the economy, it should not be surprising that there would be political ferment for changes in the regulation of alcohol sales, so that selling beer, wine, and spirits could be changed in the way that the sale of other commodities has been. But, as Americans have long recognized, alcohol cannot be sold in the same way as any other commodity. Its use can lead to risks of significant problems for public health and social welfare, and the sale of alcohol must be regulated in a manner that reduces the chances of abusive consumption.

After over a century of trying to develop an effective method for such regulation, the United States finally succeeded in the wake of Prohibition, when it developed the three-tier system that has worked so well for over eighty years. The regulatory structure of this system maximizes the opportunities to tailor regulations to local conditions and to assure that regulators remain informed about developing problems. In addition, the three-tier system provides substantial economic benefits by improving the flow of information about consumer demand, spreading marketing costs efficiently, and by minimizing some of the transaction costs that can come from trying to find the right retail outlets for the thousands of different alcoholic beverage products that are produced at any one time. Overall, the three-tier system has succeeded at maximizing the economic benefits of alcohol sales while minimizing the social risk.

Changing the operation of the three-tier system should not, therefore, be taken lightly, even if direct shipment from producers to retailers and consumers seems to offer a way to expand markets and foster the development of new suppliers and brands. When properly limited and regulated, direct shipment can be a useful addition to the alcoholic beverage industry. But such direct shipment must be maintained within the framework of the three-tier system.

Although the Supreme Court's decision in *Granholm* might have seemed to offer a chance for a dramatic expansion of direct shipment and a transformation of the regulatory scheme for selling alcohol, a careful reading of that decision, along with subsequent judicial rulings have made it clear that the three-tier system is still consistent with the Constitutional order. While states may not use the three-tier system as an instrument for discriminating against certain products on the basis of where they are made, the system can and should impose other kinds of limits on direct shipment to assure that the regulatory and economic benefits of that system remain unimpaired.

