

# ***GRANHOLM V. HEALD:*** **SHIFTING THE BOUNDARIES OF CALIFORNIA** **RECIPROCAL WINE SHIPPING LAWS**

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The temperance movement of the late nineteenth and early twentieth centuries culminated with the passage of the Eighteenth Amendment,<sup>1</sup> banning the transportation and sale of alcohol in the United States. The American public was never fully behind national Prohibition though, and the Eighteenth Amendment was soon repealed by the Twenty-first Amendment.<sup>2</sup> The interplay between the Twenty-first Amendment and the Commerce Clause,<sup>3</sup> the constitutional ban on state interference with interstate commerce, has created complex, state-specific regulatory systems and has led to economic border skirmishes in the liquor markets as producers, wholesalers, and states grapple in political and judicial forums for competitive advantages. With the rise of internet commerce and the associated ability of consumers to directly connect with hitherto unavailable or unknown alcohol producers, states have faced the question of whether to loosen their lucrative and politically tense liquor distribution regulations to allow direct sales for the benefit of small producers and consumers.

New York and Michigan attempted to “split the baby” by authorizing properly-licensed, in-state wineries to sell directly to consumers while shielding the nascent wineries from interstate competition by continuing to prohibit direct alcohol shipments from out-of-state producers. The recent Supreme Court case *Granholm v. Heald*<sup>4</sup> held that these limited exceptions to direct shipping bans violate the Commerce Clause and are not authorized under the Twenty-first Amendment. States therefore either must open their direct shipping schemes to out-of-state wineries shipping directly to customers through internet sales or shut down direct sales entirely, preventing in-state consumers and wineries from reaping the benefits of the e-commerce revolution.

This Note explores the aftermath of the *Granholm* decision and its implications for California’s wine shipping regulations. Part I outlines the history of the Twenty-first Amendment and the recent rise of e-commerce

and direct shipping laws. Part II describes the *Granholm* decision. Part III analyzes the likely effect of the Court's decision on California's new direct sales laws. This Note concludes that the *Granholm* decision will likely invalidate California's modified direct shipping statute and shift the state's involvement in direct alcohol shipments to registration and tax collection rather than barrier policing and economic protectionism.

## I. BACKGROUND

The historical background of the temperance movement, the patchwork of pre-Prohibition legislation, and the Twenty-first Amendment were critical to the Court's analysis in *Granholm*. This Part chronicles the development of congressional doctrines of noninterference in state liquor control efforts and the Court-imposed limits on these efforts. Additionally, this Part briefly outlines the growth of the internet wine market and the use of direct shipping statutes to aid small wineries.

### A. Pre-Prohibition Statutory Development

Even before nationwide Prohibition became politically feasible, the emerging temperance movement caused several states to limit or ban the production, sale, and shipment of alcohol within their borders.<sup>5</sup> The first state statutes were introduced in the 1850s, but they were largely unsuccessful and quickly repealed.<sup>6</sup> The rise of the Progressive movement rekindled a moral interest in Prohibition, however, and several states enacted bans on the production or sale of alcohol within their borders—so-called “dry” statutes—towards the end of the 19th century. While the Supreme Court held these bans to be a legitimate exercise of state police powers,<sup>7</sup> the Court took issue with attempts to limit the flow of alcohol by regulating, but not banning, its distribution and sale. These state laws had the potential to run afoul of the Commerce Clause by impermissibly dipping into the regulation of interstate commerce.<sup>8</sup> Even in the absence of federal law regulating liquor distribution or sale, the already-developed doctrine of the Dormant Commerce Clause held some areas outside of states' regulatory

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5. For a sympathetic history of the Prohibition movement, see generally NORMAN H. CLARK, *DELIVER US FROM EVIL: AN INTERPRETATION OF AMERICAN PROHIBITION* (1976).

6. Susan Lorde Martin, *Wine Wars—Direct Shipment of Wine: The Twenty-first Amendment, The Commerce Clause, and Consumers' Rights*, 38 AM. BUS. L.J. 1, 11 (2000).

7. See *Mugler v. Kansas*, 123 U.S. 623 (1887).

8. U.S. CONST. art. I, § 8, cl. 3.

purview.<sup>9</sup> In testing whether the early state regulations fell afoul of the Dormant Commerce Clause, the Court first held that early regulation schemes could not discriminate between domestic and out-of-state alcohol—all liquor was to be regulated equally before the laws of the states.<sup>10</sup> Second, the Court took a hard look at facially neutral bans, scrutinizing them for hidden discriminatory purposes or effects that would implicate the Commerce Clause, which it found in *any* ban on “imported” liquor, whether standing alone or as part of a blanket prohibition on alcohol sales.<sup>11</sup> While the bans on importation were struck down under a now-discarded “original package” doctrine of interstate commerce,<sup>12</sup> the congressional response to the rulings continues to shape Twenty-first Amendment jurisprudence.

The original package doctrine left the states unable to effectively prevent alcohol consumption within their borders, as the Court had held that any restrictions on shipping out-of-state liquor into a “dry” state had to be enacted by Congress rather than the states.<sup>13</sup> Its reasoning—that out-of-state liquor remaining in its original package was absolutely shielded from state regulation by the Commerce Clause until it was sold within the state—led Congress to pass the Wilson Act in 1890, explicitly giving states the ability to regulate imported liquor “to the same extent and in the same manner as though such . . . liquors had been produced in such State . . . .”<sup>14</sup>

While the Wilson Act clearly freed states to pass complete bans on alcohol sales within their borders or to create uniform regulatory schemes, some states attempted to use the provisions of the Wilson Act to craft regulatory schemes that benefited in-state industries to the detriment of out-of-state alcohol producers.<sup>15</sup> In *Scott v. Donald*,<sup>16</sup> the Court struck down these attempts as continuing to violate the Commerce Clause by improperly discriminating between in-state and out-of-state liquor. Instead, the Court held, the Wilson Act required “uniformity of treatment” for all liquor, whether domestic or imported.<sup>17</sup>

9. See, e.g., *Welton v. Missouri*, 91 U.S. 275 (1876).

10. See, e.g., *Walling v. Michigan*, 116 U.S. 446 (1886).

11. See, e.g., *Leisy v. Hardin*, 135 U.S. 100 (1890).

12. See E.S. Cohen, Note, *Constitutional Law—Interstate Commerce—Original Package Doctrine*, 21 VA. L. REV. 433 (1935).

13. See *Vance v. W. A. Vandercook Co.*, 170 U.S. 438, 444-45 (1898).

14. 27 U.S.C. § 121 (2000).

15. See, e.g., 1894 S.C. Acts p. 721 (requiring in-state purchase of brewing and distilling supplies and setting an in-state price ceiling).

16. 165 U.S. 58 (1897).

17. *Id.* at 100.

Furthermore, despite Congress' dispensation in the form of the Wilson Act, the states were still barred by the operation of the Commerce Clause from regulating or banning shipments of alcohol sent directly to consumers rather than to in-state retailers, as such shipments were held to remain a part of strictly interstate commerce.<sup>18</sup> This loophole had the potential to defeat effective state-based Prohibition, and once again Congress stepped in to carve out a broader sphere of influence for state liquor regulation. In 1913, Congress enacted the Webb-Kenyon Act,<sup>19</sup> specifically providing that any shipment or transportation of liquor into or within a dry state would be prohibited under federal law.

As the *Granolm* Court noted, the constitutionality of the Webb-Kenyon Act was somewhat dubious.<sup>20</sup> However, in *Clark Distilling Co. v. Western Maryland R.R. Co.*<sup>21</sup> the Court held that the Webb-Kenyon Act was constitutional, construing the Act's purpose solely to close the direct shipping loophole and holding that the Act conveyed no discriminatory powers to state regulatory schemes. Thus, states could enact laws entirely forbidding the transportation and sale of alcohol within their borders without the Commerce Clause "afford[ing] a means . . . to set such laws at naught."<sup>22</sup>

## B. Post-Prohibition Jurisprudence

The passage of the Eighteenth Amendment in 1919 temporarily suspended the growing body of law that the Court and Congress had fashioned to allow states to experiment with varying degrees of alcohol regulation and prohibition. However, with the ratification of the Twenty-first Amendment, alcohol regulation took on new life and new complexities. As the second section of the Twenty-first Amendment explicitly makes unconstitutional any "transportation or importation into any state . . . of intoxicating liquors, in violation of the laws thereof,"<sup>23</sup> there has been considerable confusion and debate regarding how far states can go in passing laws to regulate the flow of alcohol and the considerable tax revenue derived from its sale. In construing the reach of the Twenty-first Amendment, the Court has shifted in its construction of the relative weights of the

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18. See *Vance*, 170 U.S. at 452-53.

19. 27 U.S.C. § 122 (2000).

20. *Granolm*, 125 S. Ct. at 1900.

21. 242 U.S. 311 (1917).

22. *Id.* at 324.

23. U.S. CONST., amend. XXI, § 2; see also Lawrence H. Tribe, *How to Violate the Constitution Without Really Trying: Lessons From the Repeal of Prohibition to the Balanced Budget Amendment*, 12 CONST. COMMENTARY 217 (1995) (noting the incongruity of alcohol transportation becoming an offense of constitutional magnitude).

Twenty-first Amendment and the Commerce Clause. Soon after the Twenty-first Amendment was passed, the Court held in *State Board of Equalization of California v. Young's Market Co.*<sup>24</sup> that the Twenty-first Amendment authorized otherwise impermissible facial discrimination between in-state and out-of-state liquor producers. However, in the face of mounting trade barriers and scholarly disapproval for the thin support for the *Young's Market Co.* holding, the Court soon reversed course. Squarely considering the above history of the Twenty-first Amendment, the Court held that the various economic protections of the Constitution required states to treat all liquor alike, regardless of the ambiguities of the text of the Twenty-first Amendment.<sup>25</sup>

In an unusually strong opinion, the Court squarely rejected the argument that "the Twenty-first Amendment has . . . operated to 'repeal' the Commerce Clause for [liquor]."<sup>26</sup> More recently, it has also held that the Commerce Clause's nondiscrimination requirements apply to any regulatory scheme a state may set up under the Twenty-first Amendment.<sup>27</sup> Thus, the Court elaborated, "[w]hen a state [alcohol regulation] statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry."<sup>28</sup> While this interpretation of the Twenty-first Amendment would seem to give state liquor regulation something of an all-or-nothing character, as the states warned in *Granholm*, states remain free to choose among "neutral" regulatory alternatives.<sup>29</sup>

### C. The Rise of Direct Sales in Opposition to Traditional Markets

In the aftermath of Prohibition, states attempted to maintain a large degree of control over alcohol production, distribution, and sales in order

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24. 299 U.S. 59 (1936); see also *Ziffrin, Inc. v. Reeves*, 308 U.S. 132 (1939); *Joseph S. Finch & Co. v. McKittrick*, 305 U.S. 395 (1939).

25. See, e.g., *Craig v. Boren*, 429 U.S. 190 (1976) (holding that states could not violate the Equal Protection Clause under the guise of Twenty-first Amendment regulation); *Dep't of Revenue v. James B. Beam Distilling Co.*, 377 U.S. 341 (1964) (holding that states could not violate the Import-Export Clause through regulatory schemes); see also *Granholm*, 125 S. Ct. at 1903 (summarizing the academic and legal debate over the scope of the Twenty-first Amendment).

26. *Hostetter v. Idlewind Bon Voyage Liquor Corp.*, 377 U.S. 324, 331-32 (1964).

27. *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).

28. *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573, 579 (1986).

29. See *Granholm*, 125 S. Ct. at 1904-05 (rejecting argument that the Court's construction of the Twenty-first Amendment will leave states without effective regulatory ability).

to continue to promote the public health and welfare.<sup>30</sup> While states such as Pennsylvania directly sell alcohol at the retail level through state-run stores, many other states moved to a three-tier distribution system.<sup>31</sup> In this system, in-state wholesalers are the sole point of alcohol importation and are authorized to sell to licensed, in-state retailers. These retailers, in turn, are the sole distribution point of alcohol to consumers for off-premises consumption. This regulatory system allows the states to control the number of alcohol retailers and to effectively capture significant excise tax revenues from alcohol sales.

While the three-tier distribution system allows states to regulate alcohol distribution and sales effectively, it is not without problems. Small producers—generally wineries—are unable to produce alcohol with the economies of scale necessary to make interstate or intrastate distribution through licensed distributors economically feasible, as the mark-up required in such a system effectively prices them out of the wholesale market.<sup>32</sup> Furthermore, the licensed wholesalers constitute a shrinking but politically powerful group that has successfully lobbied for strict enforcement of the three-tiered distribution system and stymied laws that would allow direct sales to consumers.<sup>33</sup> While these campaigns have focused on the perceived dangers of unrestricted alcohol sales, commentators note that the wholesalers and distributor trade associations are likely to be concerned primarily about the economic effects of opening their state-mandated oligopolies to full competition.<sup>34</sup>

However, the power of the internet to connect savvy buyers and boutique sellers allows small wineries to bring their products directly to consumers by taking orders over the internet rather than seeking out distributors that specialize in boutique wines. This phenomenon of eliminating the middleman through internet sales is not limited to alcohol distribution; it is a defining characteristic of the decade-long rise of e-commerce. By reducing the costs of starting and maintaining a small business, the internet allows any producer with a website to sell directly to customers at little

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30. See Vijay Shanker, Note, *Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-first Amendment*, 85 VA. L. REV. 353, 355-56 (1999).

31. See generally *North Dakota v. United States*, 495 U.S. 423 (1990) (upholding this three-tier scheme against a Commerce Clause challenge); Martin, *supra* note 6, at 27-28.

32. For a review of the economic considerations in direct sales legislation, see Shanker, *supra* note 30, at 361-70.

33. *Id.* at 361-66; see also Alix M. Freedman & John R. Emshwiller, *Vintage System: Big Liquor Wholesaler Finds Change Stalking Its Very Private World*, WALL ST. J., Oct. 4, 1999, at A1.

34. See, e.g., Martin, *supra* note 6, at 6.

fixed cost and almost no variable cost. Traditional middlemen, such as travel agents, are cut out of the stream of commerce by the ability of producers and consumers to directly connect with very low transaction costs. Today, e-commerce accounts for 2.2% of total retail sales in America, with \$21.1 billion dollars spent online in the second quarter of 2005.<sup>35</sup>

Even before the dawn of e-commerce, California amended its direct shipping laws to implement a "reciprocity" scheme that allows out-of-state wineries to ship directly to California customers if the winery's home state allows direct shipping from California wineries in return.<sup>36</sup> The number of states taking advantage of this bargain is changing constantly, especially after *Granholt*, with twelve states currently allowing reciprocity shipments.<sup>37</sup> These laws bypass the entire three-tier structure and allow small producers to take advantage of the internet to substantially widen their markets.<sup>38</sup> These measures have been hailed as the future of winemaking and as evidence that internet commerce can substantially aid small businesses selling a nonfungible product.<sup>39</sup>

While total sales through winery direct shipments remain low, a 2003 Federal Trade Commission (FTC) study in Northern Virginia found that internet sales create substantial consumer choice: 17% of wine labels in a sample set were available online but not in local retail outlets.<sup>40</sup> Additionally, the FTC found that both mass-market and premium wines were substantially cheaper when purchased over the internet rather than through brick and mortar retail outlets.<sup>41</sup> While these findings suggest that e-commerce promises commercial success for small wineries and greater consumer choice and value, direct shipping restrictions passed in many states, sometimes in the aftermath of heavy lobbying by the wholesalers'

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35. Press Release, U.S. Census Bureau, Quarterly Retail E-Commerce Sales, 2d Quarter 2005 (Aug. 29, 2005), *available at* <http://www.census.gov/mrts/www/data/html/05Q2.html>.

36. CAL. BUS. & PROF. CODE § 23661.2 (2000), *amended by* 2005 Cal. Legis. Serv. 1737 (West).

37. Free The Grapes—Know Your State Laws, [http://www.freethegrapes.com/wine\\_lovers.html#laws](http://www.freethegrapes.com/wine_lovers.html#laws) (last visited Jan. 25, 2006). The twelve states are: Oregon, Washington, Hawaii, Idaho, Colorado, New Mexico, Minnesota, Iowa, Missouri, Illinois, Wisconsin, and West Virginia. *Id.*

38. *See, e.g.*, OR. REV. STAT. § 471.229 (2003).

39. *See generally* FED. TRADE COMM'N, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE (2003), *available at* <http://www.ftc.gov/os/2003/07/winereport2.pdf> [hereinafter FTC Report].

40. *Id.* at 18. The FTC chose Northern Virginia because the state prohibited direct shipments and the area's prices and selection could be directly compared to internet suppliers. *Id.*

41. *Id.* at 19.

associations, have severely restricted the ability of small wineries to take full advantage of the internet.<sup>42</sup>

These restrictions fall into three categories. First, some states continue to flatly prohibit direct sales by wineries and retailers, and a collection of these states have made shipping a bottle of wine a felony.<sup>43</sup> A second group of states allows direct delivery only under onerous conditions or severely limits advertising for out-of-state wineries without an in-state wholesaler representative.<sup>44</sup> Finally, a third group of states, unwilling to allow full reciprocity shipments but eager to promote burgeoning in-state wine industries, has enacted more limited direct sales laws that allow in-state wineries to bypass the three-tier system but block out-of-state producers from shipping directly to in-state consumers, thus preventing competition with in-state wineries and further reduction of wholesaler profits.<sup>45</sup> *Granholm* arose out of legal challenges to limited direct shipping statutes in New York and Michigan.

## II. THE *GRANHOLM* DECISION

### A. Facts and Procedural History

New York and Michigan both regulate alcohol production and distribution through variations on the three-tiered licensing scheme that the Court upheld in *North Dakota v. United States*.<sup>46</sup> Many in-state wineries in both New York and Michigan are small businesses that lack the ability to price their goods aggressively or to manufacture enough alcohol to make their goods palatable to wholesalers, effectively shutting them out of national competition.<sup>47</sup> To ameliorate this situation and retain substantial control over alcohol consumption via direct shipping, the two states altered their alcohol control statutes to allow limited exemptions to the three-tier system. Michigan allowed licensed, in-state wineries to sell alcohol directly to consumers but continued to require all out-of-state producers to sell their wares to in-state wholesalers through a three-tier distri-

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42. See L. Paige Woodard, *Shipping Directly to Consumers . . . Wine Not?*, 32 W. ST. U. L. REV. 63, 67-68 (2004).

43. See, e.g., FLA. STAT. § 561.545 (2005).

44. See, e.g., MINN. STAT. § 340A.417 (2000) (prohibiting direct shipments from being ordered via the internet); MO. REV. STAT. § 311.462 (2000) (restricting out-of-state shippers' ability to advertise).

45. See Freedman & Emshwiller, *supra* note 33, at A1.

46. 495 U.S. 423, 438-39 (1990).

47. See *Granholm v. Heald*, 125 S. Ct. 1885, 1892 (2005).



bution system.<sup>48</sup> New York enacted a similar scheme, but it allowed an exemption for out-of-state wineries to sell directly to customers outside the three-tier system once they established an in-state presence through a “branch factory, office, or showroom” within New York state.<sup>49</sup>

Several state residents and out-of-state wineries challenged the constitutionality of these regulatory schemes, while the states and wholesalers’ trade associations defended the schemes as valid exercises of state power under the Twenty-first Amendment.<sup>50</sup> A district court found New York’s alcohol regulations in violation of the Commerce Clause, but the Second Circuit reversed, finding that the Twenty-first Amendment granted New York the power to regulate alcohol distribution that it would not possess in other commercial fields.<sup>51</sup> The similar Michigan scheme was upheld on summary judgment by a district court, but the Sixth Circuit reversed, finding that the state had not carried its burden under *Bacchus Imports, Ltd. v. Dias*<sup>52</sup> to demonstrate that its legitimate policy objectives in crafting its alcohol regulations could not be met by nondiscriminatory alternatives.<sup>53</sup> The Court consolidated these cases and granted certiorari on a limited question: “Does a State’s regulatory scheme that permits in-state wineries directly to ship alcohol to consumers but restricts the ability of out-of-state wineries to do so violate the dormant Commerce Clause in light of [section two] of the Twenty-first Amendment?”<sup>54</sup>

## B. The Supreme Court’s Analysis

The Supreme Court had “no difficulty” concluding that the statutes at issue in both New York and Michigan facially violated the Commerce Clause by discriminating against out-of-state alcohol producers, as the laws called for “differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.”<sup>55</sup> The bulk of the Court’s opinion analyzed whether the Twenty-first Amendment saves the New York and Michigan regulatory schemes from unconstitutionality. In construing the reach of a state’s power under section two of

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48. *Id.* at 1893-94.

49. N. Y. Alco. Bev. Cont. § 3(37) (2005).

50. *Granholt*, 125 S. Ct. at 1893.

51. *Swedenburg v. Kelly*, 358 F.3d 223 (2d Cir. 2004), *rev’g* 232 F. Supp. 2d 135 (S.D.N.Y. 2002), *rev’d sub nom.* *Granholt v. Heald*, 125 S. Ct. 1885 (2005).

52. 468 U.S. 263, 263 (1984).

53. *Heald v. Engler*, 342 F.3d 517 (6th Cir. 2003), *rev’g* 2001 U.S. Dist. LEXIS 24826 (E.D. Mich. 2001), *aff’d sub nom.* *Granholt v. Heald*, 125 S. Ct. 1885 (2005).

54. *Granholt v. Heald*, 541 U.S. 1062 (2004).

55. *Granholt*, 125 S. Ct. at 1895 (quoting *Oregon Waste Sys., Inc. v. Dep’t of Env’tl. Quality of Ore.*, 511 U.S. 93, 99 (1994)).

the Twenty-first Amendment, the Court looked to the history of pre- and post-Prohibition rulings on the reach of state alcohol regulation.

Pre-Prohibition precedent generally held that, while states were allowed to control the flow of alcohol within their borders as they would any other good or service, they could not use these powers to pass laws that burdened out-of-state producers for the benefit of in-state producers or consumers.<sup>56</sup> In analyzing the reach of the Twenty-first Amendment itself, the *Granholm* Court construed the majority of post-Prohibition cases as holding that the Twenty-first Amendment was intended to return to the states the degree of control over alcohol sales and production that they held before Prohibition under the Wilson and Webb-Kenyon Acts.<sup>57</sup> Thus, echoing the majority of earlier cases, the Court held that regulatory structures and schemes that discriminate between in-state and out-of-state alcohol producers are not saved by the Twenty-first Amendment and are unconstitutional.<sup>58</sup> The New York regulatory exemption for wineries that establish an in-state presence was found to continue to discriminate between in-state and out-of-state producers; the Court noted that no winery had successfully run the complex state regulatory gauntlet to take advantage of the exemption.<sup>59</sup>

Finally, the Court considered whether the New York and Michigan statutes "advance[] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives,"<sup>60</sup> as such a purpose would save the statutes despite a finding that they were otherwise in violation of the Commerce Clause. The states argued that their exclusion of out-of-state producers was motivated by valid concerns of minors procuring alcohol via the internet and the difficulties of tax collection.<sup>61</sup> The Court, however, rejected these concerns as "mere speculation" and found that they were pretexts for discriminatory regulation in violation of the Commerce Clause.<sup>62</sup>

The dissenting justices in *Granholm* took issue with the majority's reading of the Twenty-first Amendment and post-Prohibition jurispru-

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56. *Id.* at 1898.

57. *Id.* at 1902; *see* *Craig v. Boren*, 429 U.S. 190 (1976).

58. *See, e.g., Bacchus Imports*, 468 U.S. at 276; *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573 (1986); *Healy v. Beer Inst.*, 491 U.S. 324 (1989). *But see* *State Bd. of Equalization of Cal. v. Young's Mkt. Co.*, 299 U.S. 59, 62 (1936).

59. *Granholm*, 125 S. Ct. at 1896.

60. *Id.* at 1905 (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988)).

61. *Id.* at 1905-07.

62. *Id.* at 1907.

dence.<sup>63</sup> Justice Thomas's dissent in particular interpreted the pre- and post-Prohibition cases that had come before the Court as following the *Young's Market Co.* line of cases that gave the states far greater leeway to regulate alcohol.<sup>64</sup> Thus, he would have allowed New York and Michigan to discriminate between in-state and out-of-state wineries in their direct shipping laws. Furthermore, Justice Thomas argued at length that the Webb-Kenyon Act and the cases giving rise to the Act entirely immunized state alcohol regulations from Commerce Clause review, eliminating the necessity of interpreting the Twenty-first Amendment to determine whether or not the direct shipping statutes were constitutional.<sup>65</sup> Finally, Justice Thomas' reading of the "plain meaning" of the Twenty-first Amendment would have authorized the New York and Michigan statutes regardless of the validity of his construction of the Webb-Kenyon Act.<sup>66</sup>

### III. CALIFORNIA'S REACTION TO *GRANHOLM*: AMENDING ITS DIRECT SHIPPING LAWS

California has amended its pathbreaking reciprocity laws in the aftermath of the *Granholtm* decision. While the state successfully used reciprocal shipping laws in the 1990s to open other states to the California winery market via direct shipments, the *Granholtm* decision cast serious doubt on the constitutionality of reciprocity statutes. As the Court noted:

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.<sup>67</sup>

This flat disapproval of statutorily-forced interstate economic bargaining made California's reciprocity statute a potential litigation target. However, California has attempted to avoid such litigation by changing its direct shipping law, as described below. The legality of this revised direct shipping scheme is by no means assured, but if California's new reciprocity statute stands up to inevitable legal challenges, it will assist the continued rise of e-commerce in the alcohol industry and will also place growing political pressure on nonreciprocity states to modify their alcohol distribution

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63. *Id.* at 1907-08 (Stevens, J., dissenting); *id.* at 1909-10 (Thomas, J., dissenting).

64. *See Young's Market Co.*, 299 U.S. at 62.

65. *Granholtm*, 125 S. Ct. at 1910-19 (Thomas, J., dissenting).

66. *Id.* at 1919-20 (Thomas, J., dissenting).

67. *Granholtm*, 125 S. Ct. at 1895.

laws. On the other hand, if it is struck down, California's tacit legislative objectives of opening the interstate wine market to direct retail sales will still be largely accomplished through market pressures.

### A. The Pre-*Granholm* Legislative Scheme

California's innovative reciprocity statute came into force in 1995.<sup>68</sup> After the 1994 amendment to California's direct shipping laws, California only permitted shipments from states that allowed California wineries "an equal reciprocal shipping privilege."<sup>69</sup> These shipments were neither taxed nor required to originate from a winemaker; instead, "any individual or licensee" could ship from a reciprocity state into California. This broad statutory language allowed out-of-state retailers, such as internet retailers, to ship into California, in addition to giving the California Alcoholic Beverage Control the authority to approve for reciprocity status statutes in other states that granted California wineries or retailers shipping privileges but taxed shipments. Section 3 of the enacted bill states:

It is the intent of the Legislature in enacting Section 1 of this act to encourage the adoption of reciprocal wine shipping privileges legislation in other states for purposes of improving fairness and equity for the small, family vintners and winegrowers of California. Currently, only 12 states have adopted reciprocal wine shipping privileges legislation.

The Legislature encourages the Department of Alcoholic Beverage Control to notify other states of California laws relating to reciprocal wine shipping privileges through established channels of communication.<sup>70</sup>

There is little doubt that the California reciprocity statute was intended as a bargaining tactic, as denying access to the large California wine market was a powerful card to play against small, out-of-state wineries eager to crack into large domestic wine markets through direct shipping.

The reciprocity model for state direct shipping legislation had spread to at least twelve states by the time of the *Granholm* decision, suggesting a certain measure of success.<sup>71</sup> The Court cast considerable doubt on the continued legitimacy of the reciprocity scheme, however, by stating that "states do not need, and may not attempt, to negotiate with other States

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68. CAL. BUS. & PROF. CODE § 23661.2 (2000), amended by 2005 Cal. Legis. Serv. 1737 (West).

69. *Id.*

70. 1994 Cal. Stat. 2247, 2249.

71. See *Free The Grapes*, *supra* note 37.

regarding their mutual economic interests.”<sup>72</sup> Additionally, after *Granhholm*, any state looking to develop an in-state wine industry through direct sales would have to open its borders to interstate wine shipments.

## B. The 2005 Amendment

Anticipating the outcome of *Granhholm*, the California Legislature moved to modify its direct shipping laws. Supported by winery trade groups such as the Wine Institute, the Legislature shifted California’s direct shipping scheme to a more sophisticated two-tiered scheme.<sup>73</sup> Starting January 1, 2006, direct shipping to California addresses is permitted from winemakers in any state and the requirements for recipients of direct shipments are dropped, but any winery shipping to California addresses must first obtain a direct shipping permit from the state Department of Alcoholic Beverage Control.<sup>74</sup> In addition, California has begun collecting excise tax revenue from out-of-state shipments in the same manner that in-state sales are taxed.<sup>75</sup>

The second tier of the revised shipping scheme is a modified reciprocity system that allows tax-free shipments of wine, as before, from “individuals and retail licensees” in states that afford the same privilege to California shippers.<sup>76</sup> This new statute continues to bypass the in-state retail markets and effectively opens the state up to tax-free retail sales from properly licensed retailers in other states that open their borders to California retail shipments. In theory, this could include retailers who do business entirely over the internet and have only the minimum in-state presence required to obtain a retail license in a reciprocity state. Even without tax-free internet sales lurking in the background, the revised California reciprocity statute creates an interesting set of political questions for other states, as the incentives of in-state alcohol retailers line up against wholesalers in pressuring home-state legislatures to adopt provisions that would allow for direct retail sales to California under this modified scheme.

## C. The California Statute’s Viability

The first and most important question for the new direct shipping statute is whether or not it is constitutional under *Granhholm*, as wholesalers are likely to be quick to challenge the statute’s constitutionality in order to

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72. *Granhholm*, 125 S. Ct. at 1895.

73. 2005 Cal. Legis. Serv. 1737 (West) (codified at CAL. BUS. & PROF. CODE §§ 23661.2-3 (2006)).

74. CAL BUS. & PROF. CODE § 23661.3(a)(4) (2006).

75. *Id.* § 23661.3(b)(5).

76. *Id.* § 23661.2.

prevent a further erosion of their market share in states considering retail shipping laws. While there is a certain irony in wholesalers challenging a restrictive direct shipping law after their vigorous defense of the direct shipping laws in question in *Granholm*, and in their use of the *Granholm* decision itself in this effort, the Court's decision does place the revised California statute's constitutionality in serious doubt. Even though California will allow alcohol shipments from producers in any state and thus is in technical compliance with the narrowest holding in *Granholm*, it is doubtful that the differential treatment meted out to reciprocity and nonreciprocity states' retailers will withstand a legal challenge.

The strongest argument that California's scheme is a valid exercise of state power under the Twenty-first Amendment seems to be California's uniform treatment of all direct wine shipments for tax purposes.<sup>77</sup> Neither in-state nor out-of-state producers gain any benefit over the other, as both groups are licensed and taxed identically. This rule complies with the narrowest holding in *Granholm* and the revisions in the direct shipping laws are presented as a legislative reaction to the issues presented in the case.<sup>78</sup> Nevertheless, the continued distinction between reciprocity and nonreciprocity states at the interstate retail sales level certainly has the strong scent of an attempt to bargain with other states in order to open their markets to California businesses. If nothing else, the reciprocity statute clearly distinguishes between goods moving in interstate commerce based on their state of origin. Given the Court's extremely dim view of this practice in *Granholm*, the *Granholm* decision's logic will likely invalidate California's decision to favor some states over others in its retail direct shipping laws.

#### D. The Effects of the California Statute

If California's retail reciprocity statute is upheld, it will continue to act as a pry bar for opening the retail markets of other states to internet wine sales. If, on the other hand, the reciprocity provisions of the retail direct shipping statute are found unconstitutional, the California legislature must choose between shutting down all retail direct shipping, in-state and out-of-state, or moving to an "open" retail shipping scheme similar to the one currently imposed on wineries. Such a retail shipping statute would most

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77. *Id.* This is in marked contrast to North Dakota's new direct shipping statute. In the aftermath of *Granholm*, North Dakota has moved from allowing, but taxing direct wine shipments from any state to a two-tiered system that allows tax-free shipments from states that afford North Dakota wineries the same privilege but taxes nonreciprocity states' wine shipments. See N.D. CENT. CODE § 5-01-16 (2005).

78. See S. Rules Comm., S.B. 118, S. 2005 Sess. (Cal. 2005), available at [http://www.leginfo.ca.gov/pub/bill/sen/sb\\_0101-0150/sb\\_118\\_cfa\\_20050817\\_191442\\_sen\\_floor.html](http://www.leginfo.ca.gov/pub/bill/sen/sb_0101-0150/sb_118_cfa_20050817_191442_sen_floor.html).

likely require retailers to obtain licenses and remit excise taxes to the state. The alternative—banning direct retail shipments entirely—would be strongly opposed by both winery trade groups and the growing collection of California retailers that do business over the internet in part or in whole, and it seems unlikely that the California state legislature will be interested in ending direct sales.<sup>79</sup>

For California, therefore, the *Granholtm* decision has mixed consequences. Economically, the decision is continuing to force hitherto-closed state markets to open their doors to California wineries if these states continue to allow direct shipping through the internet. Opening the California wine market to direct shipments from wineries in nonreciprocity states may marginally lower in-state sales for small California wineries as they face competition from wineries from New York and other nonreciprocity states, but this decline would likely be more than offset by the rise in direct sales from states that are now opening their borders to California winery direct shipments. Legally, though, California now finds itself on the other side of the coin as it maintains laws that would seem to enact the very sorts of trade barriers that its reciprocity scheme and the *Granholtm* decision itself were originally intended to undo.

While California's reciprocity laws were perhaps necessary in the opening stages of winery and retail direct shipping, the advent of the internet and *Granholtm's* requirement that states treat all wine equally in deciding whether it can be shipped from its producer has rendered reciprocity both unconstitutional and largely unnecessary. Were *Granholtm* to be construed in a future case to mandate an end to reciprocity retail shipping laws, a shift towards open retail shipping seems to be the most likely conclusion for California's direct shipping laws. While the state would lose its reciprocity-based economic leverage over other states' closed markets, it would benefit from the excise tax collected on shipments to California residents from now-exempt retail shippers in reciprocity states. Even without the reciprocity lever, California's continued involvement in the internet wine market will boost the market's size and visibility and push states currently banning direct retail shipments to rethink their restrictions as consumers and voters get information about the greater value and range of choices available online. The continued growth of an interstate, internet-based retail wine industry to compete with the three-tier sys-

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79. See, e.g., Wine.com, <http://www.wine.com> (last visited Jan. 26, 2006) (online-only retailer doing business from San Francisco, CA); K&L Wine Merchants, <http://www.klwines.com> (last visited Jan. 26, 2006) (California brick-and-mortar retailer with extensive online ordering and shipping options).

tem will further decrease the political and economic clout of the wholesalers and will continue to put pressure on states to streamline their traditional distribution channels, leading to greater efficiency and customer savings in the longer term.

#### IV. CONCLUSION

*Granholm v. Heald* has eliminated many of the legal justifications for discriminatory state alcohol regulations. States contemplating direct shipping laws for wineries must now decide between opening their markets to wineries across the country or shutting down direct shipping entirely. This all-or-nothing choice is made even less politically palatable by the continued rise of an internet-based retail wine market that offers consumers better prices and selection than brick-and-mortar retailers generally can offer. California's legislative attempts to aid the rise of this online market are economically wise and politically astute, but *Granholm's* clear disapproval for differential treatment of alcohol in interstate commerce makes it quite likely that the current California retail direct shipping scheme will be found to be in violation of the Commerce Clause. If the statute is struck down, California will most likely move to an open retail shipping scheme and regulate shippers to the degree required for tax purposes.