

Federal Court Strikes Indiana Three-Tier Requirement More Sales Opportunities; Face-to-Face Purchase Requirement Applies

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The Supreme Court's 2005 decision in *Granholm v. Heald*, 544 U.S. 460 (2005), was not only a victory for direct shipment of wine, but also for the "three-tier system" of alcohol distribution, which the *Granholm* opinion declared "unquestionably legitimate." *Granholm*, 544 U.S. at 489. However, in a recent opinion, Judges Easterbrook and Posner on the Seventh Circuit Court of Appeals cast doubt on the "unquestionable legitimacy" of the three-tier system.

The Seventh Circuit Court of Appeals Decides *Baude v. Heath*

On August 7, 2008, Judge Easterbrook, writing for a Seventh Circuit panel including Judge Posner, struck one element of Indiana's "direct shipment" statute as unconstitutional, and upheld another element as consistent with the Supreme Court's interpretation of the Commerce Clause. See *Baude v. Heath*, 538 F.3d 608 (7th Cir. 2008). Under the statute at issue, Indiana allowed any winery (whether located within or without the state) to ship directly to its citizens as long as two requirements were met.

First, the winery could not be licensed by any authority to sell to retailers in any state. See *Baude*, 538 F.3d at 611. Secondly, there had to be at least one face-to-face interaction with the customer during which the winery could confirm the buyer's age and other personal information. See *id.* While both provisions appear even-handed on their face because they applied to direct shipments from both in-state and out-of-state wineries, they were challenged for imposing higher costs on interstate commerce. See *Baude*, 538 F.3d at 613-15.

The Seventh Circuit struck down the requirement that a winery have no wholesaler license in any state, calling it "a needless and disproportionate burden on interstate commerce." *Id.* at 611. The court held that the clause was designed to protect Indiana's "three-tier system," under which retailers could only buy their inventory from licensed wholesalers. This is because the clause prohibited "wholesalers" in other states from shipping directly to Indiana consumers (and thus bypassing Indiana wholesalers and/or retailers). *Id.* at 611-12.

In striking down this clause, the court noted that the "vital bit of information" was that "93% of all wine comes from states that have two-tier systems," that is, where no wholesaler is required. *Id.* at 613. This includes California, Oregon and Washington, where most wineries obtain a license permitting sales to retailers or restaurants directly. *Id.* at 612. Under the "wholesaler" clause, wineries in these states that obtained licenses to sell directly to retailers would be considered "wholesalers" and could not sell directly to Indiana consumers. *Id.*

The Court could find no valid justification for benefiting Indiana's wholesalers "at the expense of Indiana's consumers and out-of-state wineries." *Id.* at 612. This is significant because it weakens protection for a state's decision to establish a three-tier system for all distribution of alcohol, whether originating in-state or out-of-state — the system which the Supreme Court in *Granholm v. Heald* stated was "unquestionably legitimate." *Granholm*, 544 U.S. at 489. The Seventh Circuit's decision in *Baude v. Heath* boldly begins to question that legitimacy.

With respect to Indiana's "in-person" or "face-to-face" purchasing requirement, Judge Easterbrook wrote that Indiana had a plausible justification for requiring at least one "on the premises" meeting before allowing a winery to ship directly to an Indiana consumer, and agreed with Indiana's explanation that it enacted the face-to-face requirement to verify the buyer's age and confirm that the wine would be used for personal consumption. *Baude*, 538 F.3d at 612-615. This motivation was sufficient to allow the provision, even if it was imperfect: the decision notes that "the face-to-face requirement makes it harder for minors to get wine. Anything that raises the cost of an activity will diminish the quantity — not to zero, but no law is or need be fully effective." *Id.* at 614. Even this small benefit from the face-to-face requirement was enough to defeat the plaintiff's challenge. As the Court noted: "[B]oth the marginal cost and the marginal benefit of Indiana's face-to-face system may be modest. That is not enough to declare a law unconstitutional — not when the effect on interstate commerce is negligible." *Id.* at 615.

What Does This Mean to Wineries Around the Country?

The *Baude v. Heath* decision is an interesting development in the continuing battle to gain direct access to consumers. On the one hand, it is a victory for out-of-state wineries that hold some sort of wholesaling license. Those wineries were considered "wholesalers" under the Indiana statute, and thus ineligible to ship directly to Indiana consumers. Now, vintners in California, Oregon and Washington that hold licenses to supply their own product to retailers can ship directly to consumers in Indiana.

Of course, Indiana still requires an initial face-to-face interaction between an Indiana consumer and the winery. However, this hurdle may not be a very big barrier to wine sales. As the Seventh Circuit noted in its discussion of the face-to-face requirement: "[O]ne winery per trip is not the only, or apt to be the usual, way to satisfy the face-to-face requirement. Many oenophiles vacation in wine country, and on a tour through Napa Valley to sample the vintners' wares a person could sign up for direct shipments from dozens of wineries." *Baude*, 538 F.3d at 613.

This does not mean that getting wholesale distribution in a state like Indiana is unimportant. The court noted that "[t]he law's principal effect may be to boost larger California (Oregon, etc.) wineries, which have established distribution systems, over smaller wineries from any state, including Indiana, that do not have wholesale distributors." *Id.* at 615. While it is easy to visit lots of wineries during one trip to California wine country, if Indiana consumers don't make that one trip, they will still only be exposed to California wines who are large enough to have distribution channels leading to Indiana retailers. As the court recognized, "[f]avoritism for large wineries over small wineries does not pose a constitutional problem." *Id.* at 615. Nonetheless, the decision is certainly a positive one for small wineries who can now ship directly to Indiana consumers who have visited the out-of-state winery.

However, on the other hand, while the *Baude v. Heath* court held that the face-to-face requirement had only "negligible" effects on interstate commerce, smaller wineries can sink or swim depending upon its ability to ship to core consumers around the country. Many small wineries would love to have a consistent customer base from states that are not yet producing much high quality wine. The ability to capture such an audience is going to make drawing wine tourists even more important for smaller wineries.

Perhaps as courts dig deeper into the economic realities of the direct shipment model, they may find that laws that hurt the ability to gain "meaningful access" to out-of-state direct shipment markets frustrate winemakers who want to sell to a few consumers in each state, but who do not produce enough to have access through the traditional three-tier system. Courts may, in time, find that this situation unconstitutionally interferes with interstate commerce, as at least one Circuit Court of Appeals has ruled since the *Baude* decision was handed down. See *Cherry Hill Vineyards, LLC v. Lilly*, 2008 U.S. App. LEXIS 26086, *22 (6th Cir. 2008) (striking down a similar "in-person" purchasing requirement and finding that such a scheme discriminates against interstate commerce "in practical effect," because the requirement "makes it economically and logistically infeasible for most consumers to purchase wine" from out-of-state wineries.)

In time, as the actual economic consequences of restrictive laws are examined, we can probably expect to see further liberalization of shipping rules. For now, all wineries can put a check mark next to Indiana on their increasingly complex spreadsheet of state-to-state direct shipment laws, but an asterix noting “face-to-face meeting required” should also be included.

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