To: **Donald S. Clark, FTC**

From: **State of North Carolina, Alcoholic Beverage Control Commission**

Re: **Comments Regarding Ecompetition, *i.e.* Wine Sales, Federal Trade Commission Workshop, October 8, 2002**

INTRODUCTION

The State of North Carolina is involved in litigation in which several individuals and an out-of-state winery have challenged the constitutionality of North Carolina laws that prohibit residents from ordering wine from out-of-state sources and having the wine shipped directly to their residences within the state. North Carolina is currently defending *Beskind v. Easley,* No. 02-1432 (4th Cir., 2002) in the Fourth Circuit Court of Appeals and is scheduled for oral argument in January 2003. The Plaintiffs in *Beskind* challenge North Carolina General Statute § 18B-102.1 which makes it unlawful, "for any person who is an out-of-state retail or wholesale dealer in the business of selling alcoholic beverages to ship or cause to be shipped any alcoholic beverage directly to any North Carolina resident who does not hold a valid wholesaler's permit." For the reasons that follow, the State of North Carolina urges the Federal Trade Commission to recognize the importance and necessity of the current state regulation over Internet wine sales.

COMMENTS

A. <u>Wine is different from other products, specifically in light of the 21st Amendment</u>.

First, it must be recognized that wine (or any other alcoholic beverage) is not cheese (*Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848, 851 (7th Cir. 2000), *cert. denied*, 532 U.S. 1002 (2001)), gasoline (*Battipaglia v. New York State Liquor Auth.*, 745 F.2d 166 (2nd Cir. 1984), *cert.*

denied, 470 U.S. 1027 (1985)), or milk (*Baldwin v. G.A.G. Seelig, Inc.*, 294 U.S. 511 (1935)), because interstate commerce in alcoholic beverages is specifically governed by the Twenty-first Amendment while trade in all other products is governed only by the Commerce Clause. Thus while the Federal Trade Commission is exploring the restriction of competition on the Internet in such areas as retailing, automobiles, real estate and funerals, the area of wine sales must be distinguished. Section 2 of the Twenty-first Amendment to the United States Constitution provides unambiguously:

> The transportation or importation into any State, Territory, or possession of the United States for delivery or use herein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.

Most obviously, the Amendment fundamentally and functionally amends the Commerce Clause of the United States Constitution with respect to commerce in alcoholic beverages. "The wording of § 2 of the Twenty-first Amendment closely follows the Webb-Kenyon and Wilson Acts, expressing the framers' clear intention of constitutionalizing the Commerce Clause framework established under those statutes. This United States Supreme Court's subsequent decisions have confirmed that the Amendment primarily created an exception to the normal operation of the Commerce Clause." *Craig v. Boren*, 429 U.S. 190, 205-06 (1976), *reh'g denied*, 429 U.S. 1124 (1977).

In one of its first decisions expounding on the meaning of the Twenty-first Amendment, the Supreme Court declared:

> The Twenty-first Amendment sanctions the right of a State to legislate concerning intoxicating liquors brought from without, unfettered by the Commerce Clause. Without doubt a State may absolutely prohibit the manufacture of intoxicants, their transportation, sale, or possession, irrespective of when or where produced or obtained, or the use to which they are to be put. Further, she may adopt measures

> reasonably appropriate to effectuate these inhibitions and exercise full police authority in respect of them. *Clark Distilling Co.* v. *Western Maryland Ry. Co.*, 242 U.S. 311, 320; *Crane* v. *Campbell*, 245 U.S. 304, 307; *Seaboard Air Line Ry.* v. *North Carolina*, 245 U.S. 298, 304; *Samuels* v. *McCurdy*, 267 U.S. 188, 197-198.

Ziffrin, Inc. v. Reeves, 308 U.S. 132, 138 (1939).

In *Hostetter v. Idlewild Bon Voyage Liquor Corp.*, 377 U.S. 324 (1964), the Court discussed at length, but did not retrench from its decision in *Ziffrin, Inc.*

> [I]n *Ziffrin, Inc., v. Reeves, 308 U.S. 132*, there was involved a Kentucky statute, "a long, comprehensive measure (123 sections) designed rigidly to regulate the production and distribution of alcoholic beverages through means of licenses and otherwise. The manifest purpose is to channelize the traffic, minimize the commonly attendant evils; also to facilitate the collection of revenue. To this end manufacture, sale, transportation, and possession are permitted only under carefully prescribed conditions and subject to constant control by the State." *Id.*, at 134. The Court upheld a provision of that "comprehensive measure" which prohibited a domestic manufacturer of liquor from delivering his product to an unlicensed private carrier. The Court noted that "Kentucky has seen fit to permit manufacture of whiskey only upon condition that it be sold to an indicated class of customers and transported in definitely specified ways. These conditions are not unreasonable and are clearly appropriate for effectuating the policy of limiting traffic in order to minimize well-known evils, and secure payment of revenue. The statute declares whiskey removed from permitted channels contraband subject to immediate seizure. This is within the police power of the State; and property so circumstanced cannot be regarded as a proper article of commerce." *Id.*, at 139.

Hostetter, 377 U.S. at 330-31.

More recently, in *North Dakota v. United States*, 495 U.S. 423 (1990), the Supreme Court re-emphasized the substantiality of the state's powers when acting pursuant to the Twenty-first Amendment. The United States sued North Dakota over its requirement that all persons bringing liquor into the state file monthly reports and that liquor shipped from out-of-state to the federal enclave within the state bear a label indicating that the liquor was destined for consumption on the enclave. The Court upheld the regulations. "Given the special protection afforded to state liquor

control policies by the Twenty-first Amendment, they are supported by a strong presumption of validity and should not be set aside lightly. *See, e.g., Capital Cities Cable, Inc. v. Crisp*, 467 U.S. at 714." *North Dakota*, 495 U.S. at 433. The Court observed,

> within the area of its jurisdiction, the State has "virtually complete control" over the importation and sale of liquor and the structure of the liquor distribution system. *See California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc.*, 445 U.S. 97, 110 (1980); *see also Capital Cities Cable, Inc. v. Crisp,* 467 U.S. 691, 712 (1984); *California Board of Equalization v. Young's Market Co.,* 299 U.S. 59 (1936). The Court has made clear that the States have the power to control shipments of liquor during their passage through their territory and to take appropriate steps to prevent the unlawful diversion of liquor into their regulated intrastate markets.

North Dakota, 495 U.S. at 431.

A state's regulation of the sale and distribution of alcoholic beverages within its borders is *the* core of its powers under Section 2 of the Twenty-first Amendment. *Capital Cities Cable, Inc. v. Crisp*, 467 U.S. 691, 713 (1984). In the exercise of its special powers under Section 2, the states are given "wide latitude" to regulate. *Joseph E. Seagram & Sons, Inc. v. Hostetter*, 384 U.S. 35, 42, *reh'g denied*, 384 U.S. 967 (1966), cited in *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 108 (1980). The cases discussed above demonstrate beyond question that the Supreme Court has never watered down the states' power to regulate the importation and transportation of liquor into its borders.

Judge Easterbrook's cogent opinion in *Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848, 851 (7th Cir. 2000), *cert. denied*, 532 U.S. 1002 (2001) correctly sums up and applies the Twenty-first Amendment. *Bridenbaugh* was brought by a group of Indiana "oenophiles," who attacked their state's prohibition on the direct shipment of wine to the purchaser by out-of-state wine retailers. Judge Easterbrook phrased the legal issue as one "pit[ting] the twenty-first amendment, which

appears in the Constitution, against the 'dormant commerce clause,' which does not." 227 F.3d 849. Indiana, like North Carolina, employs a three-tiered system to control the importation, distribution, and sale of intoxicating beverages. *Id.* at 851. Indiana justifies its system as insuring "orderly market conditions" which regulate competition and facilitate the collection of revenue. But for Section 2 of the Twenty-first Amendment, the system would violate the Commerce Clause. *Id.* "If the product were cheese rather than wine, Indiana would not be able either to close its borders to imports or to insist that the shippers collect its taxes, despite the effect on its treasury. . . . But § 2 of the twenty-first amendment empowers Indiana to control alcohol in ways that it cannot control cheese." *Id.*

Judge Easterbrook then laid out the historical background that puts the Amendment clearly in focus. The Twenty-first Amendment was adopted to assure the states' control over the importation of intoxicating beverages into their borders. State attempts at regulation had been frustrated by Supreme Court decisions, which held that although a state could control the manufacture of liquor within its borders, *Mugler v. Kansas*, 123 U.S. 623 (1887), the Commerce Clause forbade states from barring the importation of liquor to licensed sellers in the state. *Bowman v. Chicago & Northwestern Ry. Co.*, 125 U.S. 465 (1888). A subsequent attempt to totally ban the sale of alcohol was ineffective because the Court held that the resale of liquor imported into the state was still in interstate commerce as long as the liquor remained in its original package. *Leisy v. Hardin,* 135 U.S. 100 (1890). The combined effect of *Mugler* and *Leisy* was to discriminate in favor of out-of-state producers of alcoholic beverages. While states could outlaw the manufacture of alcoholic beverages within their borders, they could not legally prevent the importation into and resale of liquors in their original packages within their boundaries. *Bridenbaugh,* 227 F.3d at

851-52.

Congress responded to this anomaly by enacting the Wilson Act, 27 U.S.C.S. § 121 (2002), to give states control over the importation of alcoholic beverages "to the same extent and in the same manner as though such liquids or liquors had been produced in such State or Territory, and shall not be exempt therefrom by reason of being introduced therein in original packages or otherwise." 227 F.3d at 852. The Supreme Court, however, read the Wilson Act in such a manner as to leave the *Bowman* holding undisturbed. Thus, a state could regulate the intoxicating beverages produced within the state but not such beverages imported into it so long as the beverage remained in the original package. In 1913 Congress enacted the Webb-Kenyon Act, 27 U.S.C.S. § 122 (2002), which provided, in pertinent part, that "[t]he shipment or transportation [into a state] . . . of any . . . liquor . . . [that] is intended, by any person interested therein, to be received, possessed, sold, or in any manner used, either in the original package or otherwise, in violation of any law of such State . . . is hereby prohibited." The act was held constitutional in *Clark Distilling Co. v. Western Md. Ry. Co.*, 242 U.S. 311 (1917). On January 6, 1919, the Eighteenth Amendment was ratified. Prohibition became the law of the land and remained so until the ratification of the Twenty-first Amendment on December 5, 1933. *Midcal*, 227 F.3d at 852-53.

Judge Easterbrook summed up the present status of the law with respect to the states' power to ban the direct importation of liquors into the state by consumers:

> But the twenty-first amendment did not return the Constitution to its pre-1919 form. Section 2 tracks the Webb-Kenyon Act and effectively incorporates its approach into the Constitution. Like the Webb-Kenyon Act, § 2 incorporates state prohibitions into a federal rule; like the Webb-Kenyon Act, § 2 closes the loophole left by the dormant commerce clause, abetted by *Bowman* and *Rhodes:* direct shipments from out-of-state sellers to consumers that bypass state regulatory (and tax) systems. No longer may the dormant commerce clause be read to protect interstate shipments of

> liquor from regulation; § 2 speaks directly to these shipments. Indeed, all "importation" involves shipments from another state or nation. Every use of § 2 could be called "discriminatory" in the sense that plaintiffs use that term, because every statute limiting importation leaves intrastate commerce unaffected. If that were the sort of discrimination that lies outside state power, then § 2 would be a dead letter.

Id. at 853.

National Prohibition failed, not because the social harm was imaginary or exaggerated, but because the experiment of national Prohibition failed to solve the problem it was intended to correct. *See* John D. Rockefeller, Jr., *Foreword to the First Edition of* RAYMOND B. FOSDICK & ALBERT L. SCOTT'S, TOWARD LIQUOR CONTROL, at vii-xi (1933). The Twenty-first Amendment did not repeal the Eighteenth in order to allow the free-flow of alcoholic beverages. Rather, the Twenty-first Amendment constitutionalized the right of States and the territories and possessions of the United States to control "the importation and transportation . . . of intoxicating liquors for delivery and use therein." *See Ziffrin.* Section 2 incorporated into the Constitution what Congress had done by statute when it enacted the Webb-Kenyon Act, 27 U.S.C. 122, in 1917, which was re-enacted in 1935 after the ratification of the Twenty-first Amendment, and amended in 2000 by the Twenty-first Amendment Enforcement Act. Congress recognized that States could not effectively control the distribution and use of alcohol if they could not control the importation and transportation into their borders. The result was that the Commerce Clause was effectively amended to the extent that Section 2 empowers the States to control the importation and transportation of alcoholic beverages into their borders.

B. <u>Alcoholic Beverage Control System in North Carolina</u>.

In North Carolina, the sale, purchase, transportation, manufacture, consumption, and possession of alcoholic beverages is prohibited except as authorized by Chapter 18B of the General

Statutes. Section 18B-100 provides that

> [t]his Chapter is intended to establish a uniform system of control over the sale, purchase, transportation, manufacture, consumption, and possession of alcoholic beverages in North Carolina, and to provide procedures to insure the proper administration of the ABC laws under a uniform system throughout the State.

N. C. GEN. STAT. § 18B-100 (2001).

The sale and distribution of all alcoholic beverages in North Carolina is through the "three-tiered" system. The top tier is the manufacturer or importer of the beverage. The middle tier is the assigned North Carolina wholesaler. The bottom tier is the retailer. North Carolina's alcoholic beverage control laws require each entity in the "three tier" system to obtain applicable permits.

Consistent with the Twenty-first Amendment's prohibitions, out-of-state vendors, including wineries, are prohibited from shipping "any alcoholic beverages directly to any North Carolina purchaser who does not hold a valid wholesaler's permit." N.C. GEN. STAT. §§ 18B-102.1 and -1114 (2001). These statutes apply only to shipments of alcoholic beverages *into* North Carolina directed to North Carolina residents. An out-of-state winery or wholesaler is not prohibited, however, from selling and shipping alcoholic beverages into North Carolina. The out-of-state winery or wholesaler merely need obtain a nonresident wine vendor permit. Section 18B-1114, which governs nonresident wine vendors, provides that

> [t]he holder of a nonresident wine vendor permit may sell, deliver, and ship unfortified and fortified wine in this State only to wholesalers, importers, and bottlers licensed under this Chapter . . . The unfortified and fortified wine must come to rest at the licensed premises of a wine wholesaler in this State before being resold to a retailer. A nonresident wine vendor permit may be issued to a winery [or] wholesaler. . . outside North Carolina.

N.C. Gen. Stat. § 18B-1114 (2001).

North Carolina's alcoholic beverage control laws thereby ensure that North Carolina consumers receive alcoholic beverages *only* through a distribution system consisting of identified and licensed parties that are accountable to the State. In an affidavit prepared for the *Beskind* case, former North Carolina ABC Chairman George Bason set out the major requirements of North Carolina ABC laws:

a. the payment of excise taxes on all types of alcoholic beverages (Chapter 105, Article 2C of the General Statutes) by designated vendors;

b. the collection and payment of sales taxes on the retail sale of malt beverages and wine (Chapter 105, Article 2C, Part 5 of the General Statutes);

c. the assignment of brands and territories for wholesale distributors of wine (Article 12 of Chapter 18B of the General Statutes) and wholesale distributors of malt beverages (Article 13 of Chapter 18B of the General Statutes);

d. licensing of all vendors, both in-state and out-of-state (Article 11 of Chapter 18B of the General Statutes);

e. the protection of the public against beverages containing harmful or impure substances, beverages containing an improper balance of substances as determined by the Commission, spurious or imitation beverages, and beverages unfit for human consumption (N.C. Gen. Stat. 18B-206) via the registration and analysis of products and their labels (Commission Rules 4 NCAC 2T .0200 through .0400);

f. enforcement of the ABC laws through the investigation of complaints, and the physical inspection of the premises of vendors licensed by the Commission and the Alcohol Law Enforcement Division of the North Carolina Department of Crime Control and Public Safety, and local law enforcement agencies (N.C. Gen. Stat. 18B-203; Article 5 of Chapter 18B of the General Statutes).

The ABC system in North Carolina was established in order to maintain uniformity and control over the sale and distribution of alcohol and was enacted in its present form long before the

advent of the Internet. The three tier system of distribution is necessary to ensure traceability of products and accountability of suppliers. Internet sales of wine directly to North Carolina residents would circumvent the three tier system and the undermine the state's ability to enforce its ABC laws. This ABC system furthers the State's interest in temperance, assures that communities which limit or prohibit the sale of alcoholic beverages can do so, maintains orderly markets, monitors purchase or possession by underage individuals, and guarantees that taxes assessed will be collected. Any perceived anticompetitive effects of the present ABC system are far outweighed by the benefits of this system.

CONCLUSION

Temperaments and attitudes regarding alcoholic beverages vary greatly from state to state and effective regulation is possible only by allowing each state to monitor the importation of alcohol into its borders. When dealing with alcoholic beverages, the highest public good is not achieved by maximizing access and minimizing price. Rather, the 21st Amendment to the United States Constitution specifically allows states to regulate the importation of alcohol into their borders and distinguishes alcohol from other products. In keeping with the 21st Amendment, North Carolina has established a system of control over alcoholic beverages in order to ensure that there is an effective way to police diversions from lawful distribution and to collect state taxes.

The three tier system utilized in North Carolina allows for traceability of products and accountability of suppliers. It enables the state to monitor all alcoholic beverages that enter through its borders and ensure that products are legally manufactured and distributed. Allowing direct shipment of alcoholic beverages to North Carolina residents via the Internet would circumvent the three tier system. The result would not simply be a small variation in North Carolina alcohol

regulations, rather the destruction of the central structure of the alcoholic beverage control system. It must be remembered that wine is different. The 21st Amendment provides to the states specific powers with regard to alcohol. Furthermore, the state of North Carolina has legitimate concerns and objectives that necessitate the ABC system in its current form.