

Senate Law and Justice Committee
January 26, 2010

Testimony of Rodrigo Diaz
Executive Deputy Chief Counsel, Pennsylvania Liquor Control Board
On House Bill 291 Introduced by Representative Robert C. Donatucci

Chairman Pippy, Chairman Logan, Members of the Senate Law and Justice Committee, good morning.

My name is Rodrigo Diaz and I am the Executive Deputy Chief Counsel for the Pennsylvania Liquor Control Board. My purpose here today is to provide you with background information that may be helpful to you as you prepare to evaluate House Bill 291.

Any conversation regarding the constitutionality of a state's alcohol distribution system must begin with the United States Supreme Court decision in Granholm v. Heald, 544 U.S. 460 (2005). On May 16, 2005, the United States Supreme Court held that New York and Michigan could not prohibit out-of-state wineries from selling wine directly to their residents, while at the same time allowing in-state wineries to make such sales. While so holding, the High Court began by noting that the Constitution's dormant Commerce Clause generally prohibits states from discriminating against out-of-state economic interests in favor of in-state economic interest. The Court then held that the 21st Amendment, which repealed Prohibition, does not allow states to treat in-state and out-of-state economic interest differently unless doing so "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory purposes." While the Court acknowledged that the justifications offered by New York and Michigan - keeping alcohol from minors and facilitating tax collection - are legitimate state purposes, the Court did not accept that such purposes could only be served by discriminating against out-of-state wineries. It therefore struck down the laws in question.

I should note at this point that prior to the Granholm decision, many states, as well as four of the nine justices on the Supreme Court, believed that the 21st Amendment did afford the states with a certain amount of leeway when dealing with alcohol that was not afforded to the regulation of other products such as soda. Many of those states, including Pennsylvania, had written laws that presumed such leeway and did discriminate between in-state and out-of-state economic interests.

Accordingly, after the Granholm decision, the attorneys involved in that matter began to systematically challenge other states' laws.

Pennsylvania's laws were challenged in the case of Cutner v. Newman. 398 F. Supp. 2d 389 (E.D. Pa. 2005). In Cutner, the plaintiffs challenged the manner in which Pennsylvania treated in-state and out-of-state wineries in regards to sale and delivery of wine to Pennsylvania residents. On November 9, 2005, District Court Judge Fullum held that Pennsylvania's statutory and regulatory scheme was unconstitutional in regards to its treatment of in-state and out-of-state wineries. The court enjoined Pennsylvania from enforcing the statutory and regulatory provisions that prohibited out-of-state wineries from selling and shipping wine directly to consumers, hotels and restaurants in Pennsylvania, if in-state wineries are not subject to equivalent restrictions.

As a result of Cutner, in an attempt to treat in-state and out-of-state wineries equally, the Board, in consultation with the Attorney General's Office, began accepting and processing applications from out-of-state wineries for limited winery licenses, thereby affording such out-of-state wineries the ability to sell directly to consumers and to ship wine directly to consumers' homes. Further, the Board has not sought to enforce those restrictions in the Liquor Code that limit the amount of wine that a limited winery licensee can produce from out-of-state fruits.

While Granholm and Cutner specifically addressed the subject of the disparate treatment between in-state and out-of-state wine producers, it is safe to assume that a similar analysis would be used by the courts if they were asked to review the manner in which malt and brewed beverages are sold and distributed.

While I am sure that those who will testify after me are more intimately familiar with the specifics of beer distribution in Pennsylvania, I can briefly provide an overview. How beer is distributed in Pennsylvania depends on where it is brewed and the license held by the brewer.

Beer manufactured from outside the state as well as beer produced in-state by an alternate brewer, must be distributed under what is known as a three-tier distribution system. The manufacturer produces the beer and registers the brand with the Board. The manufacturer must then enter into a distribution agreement with an importing distributor; these agreements are typically referred to as

territorial agreements. In turn, the importing distributors resell the beer to smaller importing distributors and/or to distributors and/or retailers and/or the public.

A territorial agreement set forth the rights of the parties including the area in which the importing distributor may sell the beer in question. Such territories must be exclusive and contiguous. Such agreements, once entered into, are binding on the manufacturer and its successors, unless the manufacturer can show that it has good cause to terminate or modify the agreement. Even if the manufacturer believes it has good cause, it must give the importing distributor ninety (90) days to remedy the manufacturer's concerns before the manufacturer can modify or terminate the agreement.

Conversely, beer produced in-state by the holder of a manufacturer's license may be distributed in the manner set forth above or, the manufacturer may choose to do what is known as "self distribute," which simply means it may choose to sell directly to smaller importing distributors and/or to distributors and/or retailers and/or the public. The provisions of the Liquor Code that make it very difficult for an out-of-state manufacturer to terminate its relationship with its distributors do not necessarily apply to an in-state manufacturer.

There are other differences between an in-state and out-of-state manufacturer, such as the ability for an in-state manufacturer to acquire a retail license for use at its brewery location, but as I mentioned earlier, there are other, more directly interested parties, whom, I assume, will discuss these in more detail. What is relevant is that Granholtz suggests that each of the privileges afforded the in-state manufacturer may some day be provided to an out-of-state manufacturer, by court order, unless the Liquor Code is amended prior to that.

House Bill 291 is an attempt to eliminate the dichotomy between in-state and out-of-state manufacturers and still maintain the three-tier system. As an aside, I would note that in Granholtz, the United States Supreme Court went out of its way to state that there is nothing inherently unconstitutional about the three tier system, so the issue before the Legislature is not necessarily how to replace the three-tier system with some other form of distribution system. Nonetheless, whether to eliminate the three-tier system, whether to impose the three-tier system on all manufacturers, or whether to impose it on some manufacturers and not others, as

is the approach in House Bill 291, is a policy decision for the Legislature and the Governor to make.

If the approach adopted is to impose the three-tier system on some manufacturers but not others, based on the size of the manufacturer, then this Committee may want to review the decision by the First Circuit Court of Appeals in Family Winemakers of Cal. v. Jenkins, ____ F.3d ____ (1st. Cir. 2010). Prior to that case, a Massachusetts law that favored instate wineries over out-of-state wineries had been struck down as unconstitutional. That state's legislature responded by passing a law that gave additional distribution rights to wineries that made 30,000 gallons per year or less. The new law was challenged and on January 14, 2010, the Court of Appeals for the First Circuit struck down the statute. In doing so, the Court noted that all of Massachusetts in-state wineries made less than 30,000 gallons of wine a year and that it was obvious after reviewing the debate on the bill when it was being considered by the Legislature that the purpose of the bill was to accomplish covertly, what the previous statute had done overtly. The lesson to be learned is that the courts will look at the intent and effect of any law passed, as well as the language itself, if the law is subsequently challenged on a constitutional basis.

Thank you for your time, and I would be happy to take any questions you may have.