Craft Alcohol:
Research and Legal Analysis

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Section I: Research

In the last decade, the craft alcohol industry has become a major player in the marketplace. The American Distilling Institute and American Craft Spirits Association, and its state affiliates, represent the interests of craft distillers while multiple craft brewer organizations merged in 2005 to form the Brewers Association. The need for such groups shows the success of craft alcohol manufacturers. These groups provide strength in numbers to face common issues that continue to rise.

How states treat craft products for regulatory, taxation, and licensing purposes varies across the country with various jurisdictions having different definitions, or no definition at all, of what constitutes craft alcohol. Economic, political, and legal considerations are factors in how this emerging marketplace moves forward.

What is a Craft Alcohol Product?

The term “craft” possesses different connotations. Industry associations have outlined what they consider to be craft alcohol products.

The American Craft Spirits Association limits voting membership to licensing distilled spirits plants with less than 750,000 proof gallons distilled annually.

The American Distilling Institute offers a certification program for craft spirits and craft-blended spirits. The Institute defines craft spirits as “the products of an independently-owned distillery with maximum annual sales of 52,000 cases where the product is physically distilled and bottled on-site.” It defines a craft blender as independently-owned and operating a facility that uses any combination of traditional and/or innovative techniques such as fermenting, distilling, re-distilling, blending, infusing or warehousing to create products with a unique flavor profile.

The craft spirits certification requires the following:

- The spirit run through a still by a certified craft producer with a TTB-approved label stating "Distilled By" plus the name of the distilled spirits plant
- No greater than 25% of the distillery may be owned or controlled by a non-craft distillery
- No greater than 100,000 proof gallons in annual sales
- A "hands-on production" clause stating that craft distillers must "produce spirits that reflect the vision of their principal distillers using any combination of traditional or innovative techniques including fermenting, distilling, re-distilling, blending, infusing or warehousing."

The Brewers Association defines a craft brewer as "small, independent and traditional." This includes less than six million barrels in annual sales, no greater than 25% of the brewery may be owned or controlled by a non-craft brewer, and the use of "traditional or innovative brewing ingredients and their fermentation." The Brewers Association specifically notes that flavored malt beverages are not beers. The association's website offers best practices information including ideal safety and quality recommendations.

<u>How Do States Treat Craft Alcohol?</u>

While craft alcohol manufacturers consider their products in one light, for governance purposes the states considers these products differently. Many do not define the term; some states have rules and policies in place that regulate and license craft alcohol manufacturers by using other terms that cover the volume produced by or the geography of the manufacturer.

For example, Washington State's Washington Administrative Code Chapter 314-28 defines craft distillery in terms of the criteria used to receive a discounted fee on a distiller's

license. A craft distillery license is available to "distillers who are producing 150,000 gallons or less of spirits per calendar year. At least half of the raw materials used in the production must be grown in Washington."

Another example is Pennsylvania, whose liquor laws (Title 40 of the Pennsylvania Code) define limited winery and limited distillery. A limited winery produces "a maximum output of two hundred thousand (200,000) gallons per year." A limited distillery license is also available and "will allow the holder thereof to operate a distillery that shall not exceed production of one hundred thousand (100,000) gallons of distilled liquor per year." There is no similar license available for craft brewers, but no barrier exists for craft brewers to receive state malt and brewed beverage manufacturer licensure.

Some states provide incentives for low-volume or local manufacturers. Craft distillers in Washington State may sell their products directly to a consumer if the sale takes place on the licensed distillery site. In Montana, liquor taxes are based on gallons produced with manufacturers taxed at a lower rate for fewer gallons. Maine distillers return a reduced gross profit amount to the state.

Despite the fact that most states do not define the term craft alcohol, local and small distillers and brewers do receive attention in terms of separate licensing requirements and unique treatment in taxation and other areas.

Section II: Legal Analysis

Many times in our country's past, the courts have had to decide cases that place the Commerce Clause in conflict with the 21st Amendment. Most often these cases relate to a state's right to regulate alcohol within its borders and allegations from out-of-state entities that these laws unjustifiably favor in-state businesses. The Commerce Clause refers to Article I, Section 8, Clause 3, of the U.S. Constitution, which grants Congress the authority "to regulate commerce

with foreign nations, and among the several states, and with the Indian tribes." The Constitution also enumerates certain powers of the federal government. The 10th Amendment provides that powers not enumerated in the Constitution are reserved for the states. There is a "dormant" portion implied in the Commerce Clause that refers to the prohibition against states enacting legislation that discriminates against or excessively burdens interstate commerce. However, Section 2 of the 21st Amendment prohibits the "transportation or importation into any State… for delivery or use therein of intoxicating liquors, in violation of the laws thereof…"

The Commerce Clause v. The 21st Amendment

When a state law or a regulatory scheme places the provisions of the Commerce Clause in conflict with Section 2 of the 21st Amendment, the question becomes: is the law necessary to advance a legitimate local purpose that cannot be supported by less burdensome means, or is it truly meant to protect in-state business from out-of-state competition that would excessively burden interstate commerce? This question was raised in the U.S. Supreme Court case of *Granholm v Heald*. In *Granholm*, state laws provided a means to allow in-state wineries to sell directly to customers. However, out-of-state wineries could only sell their wine through wholesalers and retailers in accordance with the three tier system. This required the out-of-state wineries to incur higher costs to sell there wine to customers. The out-of-state wineries argued that the regulatory schemes discriminated against interstate commerce. State officials contended that the schemes were necessary to prevent underage persons from purchasing wine and to promote the collection of taxes. The U.S. Supreme Court held that the state law discriminated against interstate commerce and that the discrimination was neither authorized nor permitted by U.S. Const. amend. XXI, § 2. *See Granholm v. Heald, 544 U.S. 460, 465 (U.S. 2005).*

Although *Granholm* was considered a pinnacle case in the conflict between the 21st Amendment and the Commerce Clause, it is not the only case. Twenty one years prior to the *Granholm* decision, the U.S. Supreme Court decided *Bacchus Imports v. Dias*. In the *Bacchus* case, the state of Hawaii enacted legislation that imposed a 20% excise tax on liquor sales at wholesale; however, it exempted certain locally produced alcoholic beverages from this tax. Liquor wholesalers that imported out of state alcohol challenged the constitutionally of the excise tax and argued, among other things, that it violated the Commerce Clause and was meant to protect the local manufacturer. The Court held that the State's liquor tax exemption for the locally produced alcohol violated the Commerce Clause because it discriminated in favor of local products, and that the tax was not saved by the 21st Amendment and unconstitutional. *See Bacchus Imps. v. Dias, 468 U.S. 263, 265 (U.S. 1984).* These two cases illustrate the Court's departure from the notion that the states have unfettered rights to regulate alcohol under the 21st Amendment, especially when the issue involves in-state verses out of state alcohol manufacturers.

Exceptions: The Market Participant

It should also be noted that not all legislation/policy that supports local business is a violation of the Commerce Clause. The U.S. Supreme Court has established a limited exception to the Commerce Clause referred to as the "Market Participant Exception" to a Commerce Clause challenge. This established exception to Commerce Clause scrutiny applies when the state functions not as a regulator of the market, but rather as a market participant. In applying the market participant doctrine, the courts will first look to the level of participation by the government entity in the market. If the government is a direct participant, then the exception will apply. The U.S. Supreme Court has stated "[The] exception covers States that go beyond regulation and themselves participate in the market..." *Reeves, Inc. v. Stake, 447 U.S. 429 (U.S.*

1980). The market participant exception reflects a "basic distinction . . . between States as market participants and States as market regulators," *Reeves* at page 436*.* The Supreme Court introduced the market participant doctrine in *Hughes v. Alexandria Scrap Corp.*, which upheld a Maryland program that offered bounties to scrap processors to destroy abandoned automobile hulks. Maryland also put greater restrictions on out of state vehicle hulks prompting out of state scrap processors to challenge the program under the Commerce Clause. In *Hughes*, the court held that "…nothing in the purposes animating the commerce clause forbids a state, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others." *Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (U.S. 1976)*

The U.S. Supreme Court has decided relatively few cases dealing with the market participant exception since it was first applied in *Hughes* and has yet to take up a case that applies the exception to an issue involving alcohol. However, the Federal Fourth Circuit Court of Appeals heard a case that developed from the *Granholm* line of cases where they applied the market participant exception to a Commerce Clause challenge of a state alcohol law. In *Brooks v. Vassar*, one of the issues was a challenge to a Virginia statute that authorized state run ABC stores to sell only wine produced by Virginia wineries. *See* Va.Code § 4.1-119(A). Several out state wineries challenged this Virginia code section and claimed it violated the Commerce Clause as it unlawfully discriminated against out of state wineries by not allowing their wines to be sold in Virginia's state run ABC stores. Virginia argued that as a retailer of alcoholic beverages they were participating in the market and the Market Participant Doctrine allowed them the ability to choose which products to sell as would any other retailer. The Fourth Circuit agreed with Virginia and held that the Market Participant Doctrine applied and the statute was found constitutional. *See generally Brooks v. Vassar*, 462 F.3d 341 (4th Cir. Va. 2006).

In its analysis, the Fourth Circuit Court commented: "Virginia's choice of selling only Virginia wine is no more inappropriate than would be its choice to sell only Hershey's brand chocolate bars at a State commissary" *Brooks* at page 357. The wineries that challenged the state statute argued that the market participant doctrine did not apply because 1) the state could not participate in the market because it was also a regulator of the market, and; (2) because of the state's monopoly on spirits, it could unreasonably leverage its market power in one domain because customers at the State run store would purchase Virginia Wine instead of an out of state wine at another retail outlet.[1] The court disagreed with both of these arguments. The court found Virginia's regulation of the alcohol market not sufficient to preclude its status as a market participant. **"**To contravene the dormant Commerce Clause, a State must do more than regulate markets in which its participation happens to favor local interests. The State acts unconstitutionally when its participation in one market results in regulation of another market in which it does *not* participate." *Brooks* at page 358. As to the argument of leveraging power of a monopoly of liquor, the court held, "While there is no evidence in the record to support any claim of consumer deterrence, the Commonwealth nonetheless cannot be barred from making business choices that favor local interests on the ground that some consumers might be inconvenienced. Any choice to sell one brand or type of product rather than another could have that result." *Brooks* at page 359.

Of course, nothing is without limits and the same is true of the Market Participant Doctrine. The U.S. Supreme Court allows the market participant exception to burden interstate commerce *only* within the market in which the State participates. Thus, the State may not avail itself of the market participant doctrine to immunize downstream regulation of the market in

[1] Unlike spirits, Virginia does not control the off-premise sale of wine and wine is available through privately owned licensed retailers in the State.

which it is not a participant. *See South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82 (U.S. 1984).* A simple example of this limitation in context of a control jurisdiction might be: As in *Brooks*, a control jurisdiction may be able to sell only Virginia made wine in its own stores, but clearly could not pass a law that said only Virginia made wine may be lawfully consumed in the State. Thus, the market participant doctrine may provide the control jurisdiction more leeway within the market in which it participates; it does immunize it from unconstitutional laws that act outside of that specific market in which they participate.

<u>Facially Unconstitutional v. Purpose or Effect</u>

In challenging laws that potentially violate the Commerce Clause the courts will look to see if the laws are "facially" unconstitutional or "facially neutral" but still unconstitutional in "purpose or effect." In a facial challenge, the court will determine if "on its face" the law is unconstitutional as it is written. For example, the law challenged in the *Granholm* case was unconstitutional as written. In other words, the language of the challenged statute itself embodied express, unconstitutional discrimination between in-state and out-of-state suppliers.

A challenge to a law that is facially neutral as written can require deeper analysis and evidence because as written, the law may seem non-discriminatory, but it may still be unconstitutional as applied "in purpose or effect." For example, a facially neutral statute that prohibits wineries, whether located in or out-of-state, which produce 30,000 gallons of wine a year or more, from selling direct to in-state consumers may seem on its face to be constitutional. However, in a similar case, out-of-state wineries brought an action challenging a Massachusetts statute under the Commerce Clause on the basis that it was discriminatory not on its face, but in "purpose and effect." The Court noted that all Massachusetts wineries produced less than 30,000 gallons a year and that the statute conferred upon them a competitive advantage. *See Family*

Winemakers of California vs. Jenkins, 592 F.3d 1 (1st Cir. 2010). The Court also noted that the chief sponsor of the statute said on the floor of the House that "[w]ith the limitations that we are suggesting in the legislation, we are really still giving an inherent advantage indirectly to the local wineries." One of the chief Senate Sponsors was more direct when he said that "we should be promoting [the local wine industry] and not adopting regulations, however inadvertently, that might take away the advantage that the winery would have." *Family Wine* at page 7. Because of the legislative history, the court determined that the "purpose and effect" of the laws was to unconstitutionally discriminate against out of state producers.

In a similar case that same year, there was a challenge in the Federal Ninth Circuit to an Arizona statute that prohibited wineries, whether located in or out-of-state, which produced 20,000 gallons of wine a year or more, from selling direct to Arizona consumers. Wineries, whether located in or out-of-state, which produced under 20,000 gallons of wine a year, could ship direct to Arizona consumers. *See Blackstar Farms, LLC vs. Oliver, 600 F.3d 1225 (9th Cir. 2010).* Unlike the *Family Winemakers* case, in *Blackstar* there was no legislative history to suggest that the statute was discriminatory in purpose. Blackstar Farms conceded at the District Court level that it did not have a "smoking gun" and limited its challenge to discrimination "in effect". However, unlike *Family Winemakers,* there were two Arizona wineries that produced more than 20,000 gallons a year which lent substantial support for the argument that the statute was not discriminatory in effect. The Ninth Circuit upheld the statutes on that basis.

These two cases demonstrate that the courts will not infer the purpose of the law without evidence, but will cast a fairly large net in taking evidence as to the unconstitutional purpose.

Remedy: How the court may "fix" the problem

Once the courts decide that a law violates the Commerce Clause, it must then decide which remedy to apply. Generally, the two remedies in these cases are that of extension or

nullification[2]. In a case where the courts apply extension, they will order that the law must extend and apply to the class of out of state entities that the law discriminated against. Where the courts apply nullification, the courts will strike the statute and thus no one may take advantage of it. The courts will look to the legislative intent and regulatory scheme to determine whether to impose extension or nullification. *See generally Anheuser-Busch, Inc. v. Schnorf, 738 F. Supp. 2d 793 (N.D. Ill. 2010)*

There is also a civil remedy available to those who prevail in a state statute being found unconstitutional. This is found in Federal Code 42 USCS § 1983 and provides "Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress…" Thus, any real damages that the prevailing party can prove may be awarded to them, including attorney's fees.

<u>Conclusion</u>

For the State, Commerce Clause litigation can be time consuming and costly with the potential of paying damages to the prevailing party. The State could also have a statute stricken and left in limbo awaiting the legislature to fix the issue. State legislatures should also be aware that their statements, actions, intentions and history of dealing with "craft legislation" may also become evidence in a Commerce Clause challenge. For the in-state manufacturers that may

[2] There also may be injunctive relief which usually comes earlier in a case and may enjoin the statute from use while the case is pending.

initially receive the benefit of the unconstitutional law may also suffer as they have now built a portion of their business upon an unconstitutional law that they can no longer rely upon.

Any jurisdiction, Control or Licensed with the authority to regulate alcohol, must be wary of enacting laws that give advantages to in-state manufactures over out-of-state manufactures of alcohol. This should be of particular importance to the new growth within the craft distilling industry. Just as with the rise of farm wineries and craft breweries in our country, the maturation of the craft distillery will undoubtedly create legal issues for the states. As laws and regulatory schemes are enacted that tend to favor in-state or "craft" suppliers over out-of-state suppliers, allegations of economic protectionism will likely ensue. Typically, this happens as legislators, regulators and/or policy makers try to find ways to assist the instate manufacturer, with the intent of promoting local economic growth. Of course, the out of state manufacturer that does not receive the benefit of the law may challenge its constitutionally as in *Granholm* and *Bacchus*.

Since, there is often no bright line rule of law as to what is or is not discriminatory, it is imperative that state agencies, legislators and policy makers seek the advice of their in-state legal counsel to perform a detailed legal analysis of a proposed law that could violate the Commerce Clause. It is also advisable for the State regulators to help educate legislators, craft distillers and other stakeholders to the prevailing laws on the topic of the Commerce Clause and the 21st Amendment.

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