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## Don't Forget the Beer

Pennsylvania Must Reform its Beer Distribution Laws to Comply with the Supreme Court's Landmark Decision in *Granholm v. Heald*

By David Scott\*

Many Americans may be surprised to learn that although Prohibition ended in 1933, part of its legacy is still with us, in the form of laws advocated by its former supporters. When Prohibition's repeal appeared imminent in the early 1930s, John D. Rockefeller, Jr. (himself a teetotaler) commissioned a study to devise and recommend statutory schemes for the strict control of alcohol sales.<sup>1</sup> The resulting study, *Toward Liquor Control* by Raymond Fosdick and Albert Scott, published in 1933, proposed the “three-tier system” for beer distribution that is still with us today.

In every state, most beer sales are subject to the three-tier system, whereby manufacturers (brewers) may sell only to wholesalers, wholesalers to retailers, and retailers to consumers. The three-tier system was designed to alleviate one of Prohibition supporters' primary concerns—brewers' heavy influence over, and control of, retail establishments.

Due in large part to a lack of means of prolonging shelf life, few brewers shipped their products long distances during the early part of the 20<sup>th</sup> century. Beer was largely a local commodity, and brewers, through mechanisms such as direct ownership and financial incentives, exerted considerable influence over bars to carry solely the brewers' products to the exclusion of their competitors.<sup>2</sup> Prohibitionists viewed these “tied houses” as a means by which brewers encouraged drunkenness—leading to citizens' financial and moral ruin.<sup>3</sup>

Losing their battle to keep alcohol banned, Prohibitionists sought to minimize the influence of brewers in the post-Prohibition era by mandating the use of wholesalers to serve as a buffer between brewers and retailers. The 21<sup>st</sup> Amendment repealed Prohibition, but left control of alcohol to each individual state. Virtually every state, including Pennsylvania, has adopted some form of the three-tier system for beer distribution. Most states permit a few exceptions. Most

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common is the brewpub exception, which allows brewpubs to sell their beer on site to consumers. A number of states also allow breweries that meet certain criteria to bypass the three-tier system and self-distribute their own products. Different states use different criteria for determining who is eligible to self-distribute. For some, the determining factor is the number of barrels of beer the brewery produces in a year. Others allow all breweries to self-distribute a certain amount of beer. Pennsylvania uses the product's origin as its criterion—Pennsylvania breweries are permitted to self-distribute within the state, while out-of-state breweries are required to utilize the three-tier system.<sup>4</sup>

The United States Supreme Court has had numerous occasions to scrutinize various aspects of the three-tier system. While the system as a whole has been found constitutionally permissible, the Court has struck down schemes that exempt in-state alcohol manufacturers from the three-tier system while still requiring out-of-state manufacturers to utilize the services of wholesalers. Accordingly, Pennsylvania beer distribution law is in violation of Supreme Court precedent and must be changed.<sup>5</sup>

**The Game Changer: *Granholm v. Heald*.** The idea of exempting in-state brewers from the three-tier system is not unique to Pennsylvania or the malt beverage industry. For a number of years, Michigan and New York followed similar schemes for the sale of wine. In Michigan's case, the state offered a special "wine maker" license that allowed the holder to ship directly to in-state consumers. The permit was only available to Michigan wineries; out-of-state wineries had no option but to utilize the three-tier system. New York allowed all wineries, regardless of principal place of business, to obtain a license permitting the winery to avoid the use of wholesalers so long as their wines were made only from New York-grown grapes and the winery held an office or storeroom within the state.

New York and Michigan consumers who wished to purchase wine from out-of-state wineries too small to have distribution streams into their respective states filed suits challenging the constitutionality of the disparate treatment of out-of-state wineries. Seeing their statutorily protected industry threatened, wholesaler trade associations in both states intervened to defend the status quo. In 2005, the Michigan and New York cases were consolidated before the U.S. Supreme Court, which struck down the laws as violations of the Dormant Commerce Clause.<sup>6</sup>

The Court held that, "state laws violate the Commerce Clause if they mandate 'differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the later. . . . States may not enact laws that burden out-of-state producers or shippers simply to give a competitive advantage to in-state businesses.'"<sup>7</sup>

The Court further commented on the rationale behind the Dormant Commerce Clause:

Laws of the type at issue ... deprive citizens of their right to have access to the markets of other States on equal terms. The perceived necessity for reciprocal state privileges risks generating the trade rivalries and animosities, the allegiances and exclusivity, that the Constitution and, in particular, the Commerce Clause were designed to avoid.<sup>8</sup>

Justice Kennedy, writing for the Court, also delved into the specific concerns with the laws at issue, and in doing so, touched on key arguments against the three-tier system itself. The mandated use of wholesalers and retailers “increase[s] the cost of out-of-state wines to Michigan consumers. The cost differential, and in some cases the inability to secure a wholesaler for small shipments, can effectively bar small wineries from the Michigan market.”<sup>9</sup> In fact, it is estimated that the three-tier system adds 18 to 25 percent to consumer beer prices.<sup>10</sup>

While the Court held unconstitutional the requirement that out-of-state wineries utilize the three-tier system while exempting in-state wineries, it reaffirmed earlier rulings that the three-tier system as a whole constitutes a permissible exercise of state authority. Therefore, the fact that discriminatory statutes are unconstitutional does not mean that states are constitutionally required to allow all wineries to ship directly to consumers. It is a permissible exercise of state authority to mandate the use of wholesalers so long as the rule applies equally to in-state and out-of-state wineries. In fact, following the *Granholm* decision, Michigan banned *all* direct shipments of wine in the state.

**The Pennsylvania Framework.** Pennsylvania’s beer distribution system is nearly identical to Michigan’s wine distribution system, which was struck down by the Supreme Court in *Granholm*. Pennsylvania breweries are permitted to self-distribute their products to retailers in the state, but out-of-state breweries must go through wholesalers.<sup>11</sup>

There can be little doubt that the principles expounded in *Granholm* hold in the case of malt beverages as well, thus leaving Pennsylvania law in violation of the Supreme Court’s decision. The Court’s decision was not predicated on the peculiar characteristics of the wine industry, but on the principle that, “State laws that discriminate against interstate commerce face ‘a virtually *per se* rule of invalidity.’”<sup>12</sup> Pennsylvania’s beer laws accomplish precisely the same goal as Michigan’s wine laws did—they provide a competitive advantage to in-state breweries over out-of-state breweries by permitting in-state breweries to opt out of the three-tier system and distribute their own products.

In fact, the Pennsylvania General Assembly’s Legislative Budget and Finance Committee asserted in a recent report that Pennsylvania is in violation of *Granholm* and the laws must be changed, stating: “To address the *Granholm* decision, the PA Liquor Code needs to be amended to eliminate the disparate treatment of in-state and out-of-state manufacturers.”<sup>13</sup> In the eight years since the *Granholm* decision, Pennsylvania laws have not been changed to address the disparate treatment of out-of-state brewers. There has been only one bill introduced in the state legislature to bring Pennsylvania into compliance with the decision, and it goes about compliance the wrong way.

As noted, although states are not constitutionally permitted to require out-of-state manufacturers to utilize the three-tier system while allowing in-state manufacturers to ship directly to consumers, it does not follow that states must allow all manufacturers to self-distribute. States may require all manufacturers to utilize the three-tier system equally. House Bill 2009-291 proposed to do just that.<sup>14</sup>

Introduced in the Pennsylvania House of representatives in February 2009, the bill sought to remove the distinction between in-state and out-of-state brewers by mandating the use of the three-tier system, regardless of where the beer is produced. Initially, the bill provided an exception to the mandated use of wholesalers for brewers who produce less than 75,000 barrels a year. After a series of amendments, the exception was altered to permit brewers who produced less than 150,000 barrels in the previous year to self-distribute up to 75,000 barrels in the current year. The amended bill was passed by the House in July 2009 but was set aside by the Senate where it died at the end of the 2009-2010 legislative session.

**The Appropriate Path.** Unfortunately, while HB 2009-291 may have met its demise, the concept behind it remains alive and well, and could be resurrected in future proposals. Lawmakers should reject that approach. Instead, to bring Pennsylvania's beer laws into compliance with *Granholm*, the legislature should eliminate the required use of wholesalers for all brewers, regardless of where they are located or how much beer they produce. Allowing all brewers to self-distribute, and thus have the upmost control over their products, is the only way to promote a truly fair marketplace that will encourage competition and provide brewers with the respect and autonomy deserving of a small business. While HB 2009-291 would have brought the state into compliance with *Granholm*, and in a less restrictive way than the option taken by many other states—the complete mandate of the three-tier system—it still would have been unduly burdensome and a far cry from the true free market solution that will enhance competition and consumer choice.

The three-tier system increases the price of beer for consumers, creates market inefficiencies, and burdens the nation's more than 2,000 breweries—over 100 of which are located in Pennsylvania—with unnecessary regulatory compliance concerns. Many of these breweries are the type of small family-owned businesses that are least able to bear the financial costs associated with heavy regulatory compliance and reduced business autonomy. While small brewers across the country continue to fight for the right to distribute their own products, beer wholesalers maintain the third largest political action committee in the nation<sup>15</sup> and are quick to intervene in any legal action, such as *Granholm*, that threatens their legally protected industry.

House Bill 2009-291 would have allowed breweries that produce less than 150,000 barrels in the previous year to self-distribute up to 75,000 barrels in the current year. Accordingly, the bill allowed the overwhelming majority of the nation's more than 2,000 breweries to self-distribute their products in Pennsylvania. However, it still required the nation's largest brewers and a number of craft brewers to utilize the more costly three-tier system. Additionally, as the craft beer revolution continues to pick up pace and small breweries continue to grow,<sup>16</sup> brewers risk being caught in the bill's web of one year being permitted to self-distribute their products in Pennsylvania, to the next year being forced to utilize wholesalers, simply because they seek to keep up with the demand for their product.

Such a situation is currently playing out in other states. One example is Red Oak, a North Carolina brewery that in recent years has enjoyed a rapid increase in demand for its products. Certain peculiarities in Red Oak's products require that its beer remain cold from the brewery to the end consumer, and that it be consumed in a short period of time after bottling. Improper handling of the beer during distribution will result in an inferior product reaching consumers.

Because few wholesalers are equipped with the technology to keep their products cold during the entire shipment process or the ability to move the product from brewery to store shelves in a timely fashion, Red Oak has chosen to take advantage of an exception to North Carolina's three-tier system to self-distribute its own beer. That exception allows breweries producing less than 25,000 barrels a year to self-distribute its products within a limited geographical area.

However, in trying to keep up with demand, Red Oak is inching dangerously close to the 25,000-barrel threshold. As a result, owner Bill Sherrill may soon face the dilemma of capping his business' growth or expanding further and risking the integrity of his product. If he chooses the former, not only will he have to limit his return on investment (over \$10 million), but North Carolina will lose out on the additional economic activity and jobs that Red Oak's continued expansion will provide.<sup>17</sup>

While HB 2009-291 provided a much higher limit for self-distribution than North Carolina currently allows, one of Pennsylvania's own breweries may soon face a similar dilemma as Red Oak if a similar bill ever becomes law in Pennsylvania. Victory Brewing Company, located in Downingtown, is the nation's 26<sup>th</sup> largest craft brewery and 35<sup>th</sup> largest brewery overall, based on 2012 beer sales.<sup>18</sup> In 2012, the company produced nearly 100,000 barrels and began building a second facility in the state in order to raise production capacity to over 250,000 barrels a year.<sup>19</sup> Under HB 2009-291, Victory's increased production will result in the company losing its ability to self-distribute and force it to utilize less efficient, more costly wholesalers.

To be fair, the 150,000 barrel exception does address some of the concerns with the three-tier system noted by Justice Kennedy, namely the ability of small manufacturers to find a wholesaler to carry their products. By the time a brewery reaches the point of producing 150,000 barrels, or selling 75,000 barrels a year in Pennsylvania alone, it is likely able to find a wholesaler willing to carry its products. However, the mandated use of wholesalers for breweries that produce over 150,000 barrels still stifles economic growth and harms individuals who have invested their time, money, and effort to build a business from the ground up. The best, most effective way to avoid these harms is a complete repeal of the three-tier system.

**Conclusion.** Pennsylvania's beer distribution system, designed to provide competitive advantages to in-state brewers, is nearly identical to Michigan's wine distribution system that was the subject of *Granholm v. Heald*. Yet in the eight years since the U.S. Supreme Court declared such protectionist schemes unconstitutional, the Pennsylvania legislature has introduced (and subsequently failed to pass) only one bill to bring the state into compliance with the decision. Although the bill complied with *Granholm*, it left in place the three-tier system that was designed by Prohibitionists of another century to increase costs and make distribution of alcohol more difficult. Lawmakers should resist efforts to revive that approach.

With the current talk of shedding part of Fosdick and Scott's unlamented legacy by privatizing Pennsylvania's liquor stores, the time is ripe for the Pennsylvania legislature to also remove the chains of Fosdick and Scott's three-tier system, thus providing relief to brewers and instilling a more efficient and competitive market. Allowing all brewers, regardless of geographic origin or size, to self-distribute may not be the only way to bring Pennsylvania into compliance with *Granholm*, but it is the best method of promoting free enterprise and competition.

## Notes

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<sup>1</sup> Raymond B. Fosdick and Albert L. Scott, *Toward Liquor Control*, New York: Harper & Brothers, 1933.

<sup>2</sup> Evan T. Lawson, “The Future of the Three-Tiered System as a Control of Marketing Alcoholic Beverages,” in *Social and Economic Control of Alcohol: The 21<sup>st</sup> Amendment in the 21<sup>st</sup> Century*, Carole L. Jurkiewicz and Murphy J. Painter eds., 2008, pp. 31-32.

<sup>3</sup> *Ibid.*

<sup>4</sup> 47 P.S. § 4-431 (2012).

<sup>5</sup> No lawsuit has been filed challenging Pennsylvania’s violation of the Dormant Commerce Clause, in part because the result of lawsuit could be a complete prohibition of self-distribution rather than allowing self-distribution for both in and out-of-state producers.

<sup>6</sup> *Granholm v. Heald*, 544 U.S. 460 (2005), <http://www.law.cornell.edu/supct/pdf/03-1116P.ZO>. The Dormant Commerce Clause is an implication read into the Commerce Clause of Art. I, §8, cl. 3 of the Constitution which provides that, “Congress shall have power to . . . regulate commerce . . . among the several states.” Since the United States Congress has the power to regulate interstate commerce, courts have read into the clause an implied prohibition on states from unduly burdening or discriminating against interstate commerce.

<sup>7</sup> *Granholm v. Heald*, 544 U.S. at 472.

<sup>8</sup> *Ibid.* at 473.

<sup>9</sup> *Ibid.* at 474.

<sup>10</sup> David White, “Wholesale Robbery in Liquor Sales,” *New York Times*, April 4, 2011,

<http://www.nytimes.com/2011/04/04/opinion/04white.html>.

<sup>11</sup> 47 P.S. § 4-431 (2012).

<sup>12</sup> *Granholm v. Heald*, 544 U.S. at 476 [quoting *Philadelphia v. New Jersey*, 437 U.S. 617 (1978)].

<sup>13</sup> Legislative Budget and Finance Committee, *Study of the Economic Impact of the Brewery Industry in the Commonwealth*, at 11 (January 2013).

<sup>14</sup> H.R. 291, 2009 Pennsylvania General Assembly Regular Session,

<http://www.legis.state.pa.us/cfdocs/billInfo/BillInfo.cfm?year=2009&kind=0&body=H&type=B&bn=291>.

<sup>15</sup> White.

<sup>16</sup> Dogfish Head, one of the nation’s largest craft breweries has enjoyed 20 percent year-over-year increases in sales in recent years, according to the company’s “off-centered general counsel” Shauna Barnes. Don Tartaglione, “The ‘off-centered’ GC,” *National Law Journal*, December 26, 2012,

<http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202582247122&thepage=1>.

<sup>17</sup> “The Making and Distribution of Beer if a Highly Regulated Business,” *Beaufort Observer*, May 1, 2013,

<http://www.beaufortobserver.net/Articles-NEWS-and-COMMENTARY-c-2013-05-01-266628.112112-The-making-and-distribution-of-beer-is-a-highly-regulated-business.html>.

<sup>18</sup> “Brewers Association Releases Top 50 Breweries of 2012,” News Release, Brewers Association, April 10, 2013,

<http://www.brewersassociation.org/pages/media/press-releases/show?title=brewers-association-releases-top-50-breweries-of-2012>.

<sup>19</sup> Joe Satran, “Victory Brewing Company, Veterans in a Field of Craft Novices, Preps for Expansion,” *Huffington Post*, October 24, 2012, [http://www.huffingtonpost.com/2012/10/24/victory-brewing-company\\_n\\_2008689.html](http://www.huffingtonpost.com/2012/10/24/victory-brewing-company_n_2008689.html).