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MEMORANDUM

Date: January 31, 2018

To: Danelle Romain, Executive Director,
Oregon Beer & Wine Distributors Association

From: Steven Wilker

Re: Constitutionality of Senate Bill 1564

You have requested an analysis of potential constitutional issues concerning Senate Bill 1564 which is being introduced at the 2018 Regular Session of the Oregon Legislature. SB 1564 would give in-state Oregon distillers a discriminatory preference of the kind that the U.S. Supreme Court has repeatedly struck down as violating the Commerce Clause.

Background

In brief, SB 1564 would permit Oregon distillers to establish tasting rooms at or in close proximity to their distillery premises at which they could "sell distilled liquor at the tasting room in sealed containers at retail for off-premises, off-location consumption."

Under existing law, all distilled liquor to be sold in the State of Oregon, whether produced in state or out of state, is sold to the Oregon Liquor Control Commission (OLCC). The OLCC licenses restaurants and bars and others to sell distilled liquors (as well as malt beverages and wines) for on-premises consumption. Those facilities purchase all distilled liquors from the OLCC. Additionally, the OLCC appoints sales agents who operate retail liquor stores where distilled liquors are sold for off-premises consumption. The OLCC establishes the retail price for all distilled liquors sold for off-premises consumption. After paying distillers the wholesale price of the distilled liquors and the cost of any commissions paid to the sales agents who operate liquor stores, the remaining proceeds from the sale of distilled liquors constitute government revenues collected by the OLCC on behalf of the State and are deposited in the general funds of the State subject to legislative appropriations. Distillers effectively pay a tax to the state equal to the difference between the wholesale and retail prices of their products.

SB 1564 would permit Oregon distillers to sell distilled liquors directly to consumers, but only at the retail price established by the OLCC. Under the proposed bill, however, the distiller would receive the entire retail price per bottle, rather than wholesale price it would receive upon a sale to the OLCC, up to a total of $500,000 in annual sales under the tasting room permit. Because the OLCC marks up the wholesale price by approximately 110%, for each $500,000 in retail

sales made by the OLCC, a distiller collects less than $240,000.[1] Thus, SB 1564 would have the effect of transferring more than $260,000 in general fund revenue to each Oregon distiller that has a tasting room permit and $500,000 in annual retail sales under that permit. And, a licensee that has multiple licensed distillery premises could have a separate permit for a tasting room at or in close proximity to each distillery premises, with a separate limit of $500,000 in annual sales.

Because the tasting room permit provided for by SB 1564 would only be available to distillery licensees in Oregon, it is by definition not available to out-of-state producers of distilled liquors, which must sell their products to the OLCC at wholesale and are prohibited by existing law from making retail sales. Thus, SB 1564 would treat out-of-state producers differently than in state producers by not making available to them the tax rebate that is effectively made available to in state distillers with the new tasting room permits.

Constitutional Analysis

The Twenty-First Amendment to the United States Constitution repealed prohibition (section 1) and restored to the states the right to regulate the transportation, importation, and use of intoxicating liquors (section 2). But the power to regulate does not include the power to discriminate against or unduly burden interstate commerce. Specifically, under the Supreme Court's dormant Commerce Clause doctrine, state regulations that favor in state producers over out-of-state producers are invalid and cannot be enforced.

For example, in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), the Supreme Court struck down Hawaii's 20% excise tax imposed on sales of liquor at wholesale, because locally produced alcoholic beverages – okolehao (brandy) and pineapple wine – were exempt from the tax. "A cardinal rule of Commerce Clause jurisprudence is that '[n]o State, consistent with the Commerce Clause, may "impose a tax which discriminates against interstate commerce ... by providing a direct commercial advantage to local business."'" *Id.* at 268 (internal cites omitted).

Ten years later, in *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994), the Supreme Court invalidated a Massachusetts pricing order that imposed an assessment on all milk sold to retailers, both from in state and out-of-state sources. About two-thirds of the milk was produced out of state. The amounts collected from the assessment were then distributed solely to Massachusetts dairy farmers. The Court found the scheme to be

> clearly unconstitutional. Its avowed purpose and its undisputed effect are to enable higher cost Massachusetts dairy farmers to compete with lower cost dairy farmers in other States. The "premium payments" are effectively a tax which makes milk produced out of State more expensive. Although the tax also applies to milk produced in Massachusetts, its effect on Massachusetts producers is entirely (indeed more than) offset by the subsidy provided exclusively to Massachusetts dairy farmers. Like an ordinary tariff, the tax is thus effectively imposed only on out-of-state products. The pricing order thus allows Massachusetts dairy farmers who produce at higher cost to sell at or below the price charged by lower cost out-of-state producers.

[1] $500,000/2.1 = 238,095.24.

Id. at 194-95. The Court specifically rejected the state's argument that because each component of the pricing order was constitutional standing alone, the combination could not be unconstitutional. "[E]ven though the tax is applied even-handedly to milk produced in State and out of State, most of the tax collected comes from taxes on milk from other States. In addition, the tax on in-state milk, unlike that imposed on out-of-state milk, does not impose any burden on in-state producers, because in-state dairy farmers can be confident that the taxes paid on their milk will be returned to them via the Dairy Equalization Fund." *Id.* at 199 n.16.

And, eleven years later, *Granholm v. Heald*, 544 U.S. 460 (2005), the Supreme Court again struck down discriminatory regulations on Commerce Clause grounds, this time concerning direct shipment of wine, and rejected the argument that section 2 of the Twenty-First Amendment allows states to impose regulations that discriminate against out-of-state producers. The Court also rejected the argument that Congress had ceded its authority over interstate commerce involving alcoholic beverages to the states by legislation.

Granholm resolved cases arising in Michigan and New York. As the Court explained, "the three-tier system is, in broad terms and with refinements to be discussed, mandated by Michigan and New York only for sales from out-of-state wineries. In-state wineries, by contrast, can obtain a license for direct sales to consumers. The differential treatment between in-state and out-of-state wineries constitutes explicit discrimination against interstate commerce." *Id.* at 467. Specifically, Michigan law allowed in-state wineries to ship directly to consumers, but banned out-of-state wineries from doing so, forcing them to sell through Michigan wholesalers and retailers in order to reach Michigan consumers. New York's law similarly permitted in-state wineries to ship wine directly to consumers. Out-of-state wineries, however, had to establish a physical distribution operation in the state in order to ship directly to New York consumers. In both cases, in-state producers were given preferential access to in-state consumers, while out-of-state producers were required to incur additional costs that would drive up the cost of their products and make them less competitive than in-state products. The Court found the Michigan and New York preferences for in-state producers unconstitutional.

SB 1564 is essentially indistinguishable from the schemes struck down in *Bacchus*, *West Lynn Creamery*, and *Granholm*.[2] It would create a preferential scheme that is only available to in-state producers that allows them to sell direct to consumers, while not making an equivalent opportunity available to out-of-state distillers. Moreover, that is a feature of the bill, not a by-product. Courts, including the Supreme Court, have examined the motivations of legislatures in enacting statutes that promote in-state businesses at the expense of out-of-state businesses in evaluating the constitutionality of such legislation. An out-of-state distiller effectively pays tax of more than $260,000 for each $500,000 of retail sales of its products in Oregon, while SB 1564 would permit an Oregon distiller to pay no tax on up to $500,000 in retail sales, more than doubling its margin. As a result, the Oregon distiller would be given the same kind of preference that the Supreme Court has repeatedly struck down as violating the Commerce Clause.

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[2] To the same effect, in 2003, the Washington Supreme Court struck down Washington's wholesale distributor/supplier equity agreement act (RCW 19.126) as applied to wine, because it exempted domestic Washington wineries from the requirements of the law. *Mt. Hood Beverage Co. v. Constellation Brands, Inc.*, 149 Wash.2d 98 (2003) (exempting in-state suppliers from limitations on termination of distribution agreements constituted discrimination against interstate commerce in violation of the Commerce Clause).

About the author

Steven Wilker is partner in Tonkon Torp LLP, where he has practiced for more than 25 years, following judicial clerkships with the Honorable Edwin J. Peterson, Chief Justice/Associate Justice of the Oregon Supreme Court, and the Honorable Stephen V. Wilson, United States District Judge for the Central District of California in Los Angeles. Mr. Wilker has a broad-based trial and appellate practice that includes civil and Constitutional law as well as intellectual property, information privacy and security, financial services, media and technology law and complex commercial litigation. He has represented distributor and supplier clients in the beverage distribution industry for more than 20 years. He is recognized by *The Best Lawyers in America*® in First Amendment and Commercial Litigation. In addition to his trial practice, Mr. Wilker has presented arguments in cases at the U.S. Supreme Court, the U.S. Courts of Appeal for the Federal and Ninth Circuits, the Oregon Supreme Court, the Oregon Court of Appeals, the California Court of Appeal, and the Washington Court of Appeals.