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Breaking Down the Costco Case

Background: What is Costco?

In December 2005, a federal court judge in Washington State heard arguments for summary judgment on a suit brought by big box retailer Costco challenging many aspects of Washington regulations governing sales to retailers by wineries and wholesalers. The case, *Costco Wholesale Corp. v. Hoen*, questions whether those regulations violate the Commerce Clause because Washington Costco stores can buy directly from in-state wineries, but not from wineries located in other states. The case also identifies other regulations which constitute possible anti-trust violations because of excessive regulation and state sanctioned anti-competitive practices.

Discrimination Issue

Self-distribution rights for only in-state wineries appears to be a violation of the Commerce Clause under the Supreme Court ruling in the *Granholm* case, because it is a clear situation of protectionist treatment of in-state over out-of-state economic interests. While such discrimination may be allowed if there is a legitimate local purpose which cannot be served by reasonable nondiscriminatory alternatives, the Washington court did not find such a purpose and ruled that the discrimination was unconstitutional. However, Judge Pechman stayed her judgment in order to give the legislature until April 14, 2006 to decide how to treat in-state and out-of-state producers in an even handed manner. If the legislature fails to act, the Court order will deny in-state producers the ability to self-distribute their wine and beer. A majority of other states have similar laws allowing only in-state wineries to self-distribute.

Anti-Trust Issue

Costco does not just challenge the distribution system under the Commerce Clause; it also challenges several provisions of Washington liquor law under the Sherman Anti-trust Act, calling them restrictions on price competition and trade. The Act gives the federal government the right to regulate interstate commerce and states that it is illegal for any company or state to put restraints on interstate trade. There is an exception for state sanctioned activities but that exception requires clear definition of state interests and active supervision to promote those interests.

The Costco case questions parts of Washington's liquor practices, including:

- Prohibiting volume discounts on the sale of beer and wine
- Requiring distributors to sell beer and wine at a uniform price to all retailers (the "uniform pricing" requirement)
- Prohibiting retailers from buying beer and wine on credit
- Requiring beer and wine prices from manufacturers and distributors be posted with the LCB and no sales can be made at other than the posted prices (the "posting" requirement)
- Requiring beer and wine prices to be posted in advance of their holding dates and be held for a full month (the "holding" requirement)
- Requiring a 10% minimum mark-up on beer and wine prices from manufacturer to wholesaler and wholesaler to retailer (the "minimum mark-up" requirement)

- Requiring distributors to sell at delivered pricing, even if a retailer pays the freight and picks up the goods from a distributor (the “delivered pricing” requirement)
- Prohibiting retailers from selling beer and wine to other licensed retailers
- Prohibiting a retailer from receiving beer and wine at its own warehouse or from bonded warehouses to transfer to its various licensed locations (the “central warehousing” ban)

Judge Pechman heard arguments on three summary judgment motions pertaining to anti-trust provisions (Costco seeking to overturn price posting, the wholesalers arguing that the regulations aren't anti-trust violations, and the LCB arguing that the regulations are protected by state action immunity). She ruled that these claims could not be dealt with in a summary judgment and required more factual information given during a trial. The contested regulations listed above will be heard in a trial set for March 2006.

What Does the Ruling on Self-Distribution Mean for Wineries?

The issue of self-distribution has rarely been addressed in litigation, and remains something that will be decided in the courts and legislatures. Though the *Costco* case may set the precedent on self-distribution, Virginia wineries have been battling this issue in the case *Brooks v. Danielson*. In April 2005, a Federal Court judge ruled that wineries in the state may not sell wine directly to retailers and restaurants (due to the discriminatory nature of the state's laws – allowing only in-state wineries those privileges), nor can ABC stores exclusively carry Virginia wines. The case is on appeal to the 4th Circuit Court of Appeals, but the Court has yet to decide if they will hear it.

It is unclear how state legislatures will respond to this challenge. Wineries must be prepared to face this issue in their own state. In Washington, wineries will have to work on getting legislation drafted and passed before April, though they will face strong wholesaler opposition to extending the right of self-distribution to out-of-state wineries. One solution for wineries to consider is a size-based option – meaning wineries that fall into the small producer category can self-distribute, while larger wineries must continue to use the traditional three-tier system. Another is to place limits on the amount of wine any winery may self-distribute.

The issue of in-state distribution and discrimination has already been taken up by several states. In the summer of 2005, the Louisiana legislature passed a bill taking away the rights of in-state wineries to self-distribute. Kentucky wineries are facing similar pressure this year. Following the *Costco* ruling, there will be severe pressure on states with discriminatory distribution laws to come up with revised statutes. It is up to wineries to convince lawmakers that opening up the state, rather than banning all self-distribution rights, is the best option.