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“Legal Issues Concerning State Alcohol Regulation”

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Introduction

Mr. Chairman, Ranking Member Coble, and other distinguished members of the Judiciary Committee Subcommittee on Courts and Competition Policy, I want to thank you for giving me the opportunity today to speak about the interrelationship between antitrust laws and state regulation of alcohol consumption. More specifically, I hope today to emphasize those instances when state regulation of alcohol utterly fails to do more than present an aura of regulation to otherwise private activity, to the detriment of consumers and distributors of alcohol, and how such activity is undeserving of antitrust immunity. My remarks here today are my own. I speak today based upon my experience as an Antitrust Division trial attorney focused on deregulated industries, as an economist, and as a law professor whose research and writing has focused on antitrust issues arising in the context of regulated/deregulated industries.¹

¹ The term “deregulation” is a bit of a misnomer. See Harry First, *Regulated Deregulation: The New York Experience in Electric Utility Deregulation*, 33 LOY. U. CHI. L. J. 911 (2002)(noting that New York’s electricity market was not deregulated, but in fact replaced “one regulatory system with another.”).

The Role of State Action Doctrine

The State Action Doctrine is the first line of defense against antitrust challenge to a state imposed restraint against competition. In recent times, the state action doctrine has been greatly expanded to encompass all types of regulatory activity, often even when such restraints do not seek to displace competition with regulation. While this is not the role that state action doctrine should play in modern antitrust analysis, the fact of the matter is that it is extremely difficult for a plaintiff to challenge anticompetitive restraints when the state is involved.

A successful state action defense rests upon the two prongs put forward in *California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc.*² In order to be exempt under the state action doctrine, (1) the challenged restraint must be "one clearly articulated and affirmatively expressed as state policy," and (2) the policy must be "actively supervised" by the state itself.³ The Supreme Court in *Midcal* found that California's wine pricing program – a program that required wine producers to file "fair trade contracts" or post a resale price schedule– did rest upon a clearly articulated state policy. However, the Court found that the policy was not actively supervised:

The State simply authorizes price-setting and enforces the prices established by private parties. The State neither establishes prices nor reviews the reasonableness of the price schedules; nor does it regulate the terms of fair trade contracts. The State does not monitor market conditions or engage in any "pointed reexamination" of the program. The national policy in favor of competition cannot be thwarted by casting such a gauzy cloak of state involvement over what is essentially a private price fixing arrangement. As Parker teaches, "a state does not give immunity to those who violate the Sherman Act by authorizing them to violate it, or by declaring that their action is lawful."⁴

² *California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc.*, 445 U.S. 97 (1980).

³ *Id.* at 105.

⁴ *Id.* at 106.

The metaphor of the “gauzy cloak” suggests a concern that the state in fact ought to play a role in authorizing and directing the conduct, not merely serve as pretext to the creation of an exemption for a private agreement. In the case of liquor regulation, states have traditionally placed a “gauzy cloak” of regulation without any supervision of pricing or concern about how such cartel-fostering injures consumers.

Midcal emphasizes the relationship between the state and the monitoring of the authorized conduct. However, there is a subsidiary notion that the conduct authorized and supervised must promote “state policy.” The court in *Midcal* noted several times the “national policy in favor of competition,”⁵ and the weighing of that policy against the state’s interest in regulation. The notion is that if regulation is to displace competition policy, then the state must provide some means of assuring that its policies are carried forth. The tangential relationship between the state and the conduct at issue is insufficient. The requirement is that the conduct be authorized and supervised.

The Supreme Court’s most recent pronouncement on the state action doctrine, *FTC v. Ticor Title Insurance Company*,⁶ involved the setting of title search fees and administrative costs by rate bureaus licensed by the state and authorized to engage in joint price setting. The rates became effective unless rejected by the state. The Court rejected the use of these negative rate options as failing to qualify as active supervision when in fact the option had never been utilized. Here again the Court focuses on the tension between regulation and antitrust. However, the Court makes a statement that hints at the complementariness of the two regimes:

⁵ 445 U.S. at 101, 106, 110 n. 11, and 113.

⁶ *FTC v. Ticor Title Insurance Company*, 504 U.S. 621 (1992).

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If the States must act in the shadow of state-action immunity whenever they enter the realm of economic regulation, then our doctrine will impede their freedom of action, not advance it. The fact of the matter is that the States regulate their economies in many ways not inconsistent with the antitrust laws. For example, Oregon may provide for peer review by its physicians without approving anticompetitive conduct by them. . . . Or Michigan may regulate its public utilities without authorizing monopolization in the market for electric light bulbs. . . . So we have held that state-action immunity is disfavored, much as are repeals by implication. . . . By adhering in most cases to fundamental and accepted assumptions about the benefits of competition within the framework of the antitrust laws, we increase the States' regulatory flexibility.⁷

In other words, the “default” rule of competition provides the backdrop for most state regulation. This strong presumption can be overcome, but only with clear showing that the state seeks some framework *apart from competition* to organize industrial activity within a particular industry, sector, or business.

Moreover, the cases focus on the relationship between the conduct in question and the regulation at issue. The notion of a broad exemption or exemption by proximity was anathema to the purpose behind the antitrust laws. This principle was first articulated in the “compulsion requirement,”⁸ which was later relaxed with the requirement that the conduct was merely authorized by the state and perhaps that the conduct need only be “foreseeable.” In other words, the state action doctrine was an exemption for purposes of engaging in particular conduct, not a blanket exemption for an industry subject to regulation.

Broad regulation does not necessarily constitute active supervision, as the court in *U.S. v. Rochester Gas & Electric*⁹ noted. *RG&E* argued that its contract with the

⁷ *Id.* at 635-636.

⁸ See, e.g., Arbara P. Pletcher, *State Action Immunity and the Compulsion Requirement: Joint Ratemaking in Intrastate Trucking*, 71 CALIF. L. REV. 1557 (1983).

⁹ 4 F.Supp.2d 172 (W.D.N.Y. 1998).

University met the active supervision prong of the *Midcal* test because the state regulatory authority had approved the contract. The Court responded:

The Public Service Commission, however, is not charged with enforcing federal antitrust law, and did not review the contract to determine whether or not it violates that law. The fact that the New York Public Service Commission has approved the contract at issue does not mean that the State has authorized, and shielded from federal law, allegedly anticompetitive behavior.¹⁰

The notion that mere approval of a contract does not shield the contract with an exemption from the antitrust laws suggests that the regulatory agency would have to do more than merely rubber stamp the conduct at issue.¹¹

Which Alcohol Regulations Have Undergone Antitrust Scrutiny?

With the preceding as background, it is understandable why a small class of state alcohol regulations have been scrutinized under the antitrust laws. In most instances, one particular type of state regulation, the “post-and-hold” pricing requirement, serves as a gauzy cloak that protects and fosters collusion to the detriment of consumers.

For example, in *TFSW, Inc. v. Schaefer*,¹² the court examined Maryland’s “post-and-hold” pricing system, by which wholesales were required to file price schedules with the comptroller. These prices were required to be followed for at least a month following posting. Making the scheme even more disconcerting from an antitrust perspective was

¹⁰ 4 F.Supp. 2d. at 176.

¹¹ As the Supreme Court noted in *Fisher v. City of Berkeley*, 475 U.S. 260, 267-68 (1986), “Not all restraints imposed upon private actors by government units necessarily constitute unilateral action outside the purview of § 1. Certain restraints may be characterized as “hybrid,” in that non-market mechanisms merely enforce private marketing decisions. . . . Where private actors are thus granted “a degree of private regulatory power,” . . . the regulatory scheme may be attacked under § 1.”(internal citations omitted). Thus, states which unilaterally imposed regulatory schemes and enforce such schemes via active state supervision are typically shielded from the antitrust laws.

¹² 242 F.3d 198 (4th Cir. 2000).

that the posted prices were made available to competitors prior to becoming final. Market participants were then given the opportunity to adjust their prices accordingly. In other words, deviations from standard prices could be detected and potentially punished, with the vehicle of punishment being a holding period. Volume discounts were also verboten under the rule.

The court rejected the restraint as lacking in active supervision by the state: “

The post-and-hold system is a classic hybrid restraint: the State requires wholesalers to set prices and stick to them, but *it does not review those privately set prices for reasonableness*; the wholesalers are thus granted a significant degree of private regulatory power. The volume discount ban is a part of the hybrid restraint because it reinforces the post-and-hold system by making it even more inflexible. Wholesalers post their prices as required, and discounts of any nature are prohibited by regulation.”¹³

The court in TSW properly noted that the history of impermissible restraints in the context of liquor regulation surrounds attempts at resale price maintenance. The *Midcal* case discussed earlier is an example of this. The Supreme Court also wrestled with such restraints in *Schwegmann Bros. v. Calvert Distillers Corp.*,¹⁴ and *324 Liquor Corp. v. Duffy*.¹⁵ In each instance, the role of the state regulator was as a rubber stamp of prices set by private actors.¹⁶

¹³ 242 F.3d at 209.

¹⁴ 341 U.S. 384 (1951)(a state’s endorsement of a resale price maintenance scheme involving whiskey and gin insufficient for purposes of state action doctrine).

¹⁵ 479 U.S. 335 (1987)(post-and-hold pricing scheme lacks active supervision by the state).

¹⁶ Other cases have similarly eschewed post-and-hold regulations. See *Beer & Pop Warehouse v. Jones*, 41 F.Supp.2d 552, 560-62 (M.D.Pa.1999) (Pennsylvania post-and-hold beer pricing statute); *Canterbury Liquors & Pantry v. Sullivan*, 16 F.Supp.2d 41, 47-48 (D.Mass.1998) (Massachusetts post-and-hold liquor pricing regulation). *Cf. Battipaglia v. New York State Liquor Authority*, 745 F.2d 166 (2d Cir.1984)(upholding by divided panel post-and-hold regulations for New York wholesale liquor prices). But See 1 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 217, at 308-09 (2d ed. 2000) (“Given the great danger that agreements to post and adhere will facilitate horizontal collusion, the [Battipaglia] dissent’s position is more consistent with” the Supreme Court’s analysis of such restraints).

Similarly, in *Costco v. Maleng*,¹⁷ it is the post-and-hold pricing scheme which takes the brunt of antitrust attack. Costco challenged numerous restraints established by the state, including a warehousing prohibition, a uniform pricing rule requiring each winery and brewery to sell at the same price to each distributor, a minimum markup provision, a ban on volume discounts, a ban on sales on credit, a ban on retailers selling to other retailers, and a delivered price requirement. The only restraint that failed to be protected from antitrust attack was the post-and-hold pricing mechanism, despite, in my opinion, very good reasons for some of the other restraints to not withstand antitrust scrutiny as well.

In sum, state liquor regulation as a whole is not under serious antitrust attack. Instead, in a few instances in which the states have utterly failed to regulate in any meaningful way, instead seeking to rubber stamp private activity, the courts have seen through the gauzy cloak of state regulation that merely serves as enforcing and perhaps compelling overt or tacit collusion in the market for alcoholic beverages.

Should State Alcohol Regulations Not Otherwise Immunized By Judicially Created Immunities and Exemptions Be Granted An Express Antitrust Immunity?

In light of the foregoing, the case for an express antitrust immunity for state liquor regulation is hardly compelling. The risks of granting such immunity are severe, and must be carefully considered.

¹⁷ 522 F.3d 874 (9th Cir. 2008).

In a limited number of circumstances, Congress has expressly and unambiguously exempted certain activities from the antitrust laws.¹⁸ Even in these circumstances, controversy over the scope of the express exemption can emerge around the periphery of the exemption. For example, the Congressional exemption from federal antitrust regulation for the insurance industry under the McCarran-Ferguson Act¹⁹ is expressly limited to "the business of insurance" is only available to the extent the conduct in question is regulated by state law, and is further limited by a proviso excepting from the exemption conduct amounting to a "boycott", "coercion" or "intimidation." Controversy has occurred about the meaning of each of these limitations upon the scope of the express exemption.

Apart from the inherent ambiguities of language created by statutory immunities, the difficulty with statutory immunity is manifold. First, in many instances, the economic rationale for the statutory immunity is uncertain.²⁰ The industries or firms seeking the statutory immunity may not have laid out a compelling rationale for the elimination of the default rule of competition. Even if the proponents of the statutory immunity were to have laid out a compelling case, their analysis may not have been subject to the sunlight of an open decision-making process that has heard from all stakeholders. Such

¹⁸ For a list of statutory immunities, see DARREN BUSH, GREGORY K. LEONARD & STEPHEN ROSS, A FRAMEWORK FOR POLICYMAKERS TO ANALYZE PROPOSED AND EXISTING ANTITRUST IMMUNITIES AND EXEMPTIONS (2005)(hereafter "Immunity Framework"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=95659739-40. The list includes statutory modifications to antitrust review of conduct as well as full immunizations from the antitrust law.

¹⁹ 15 U.S.C. §§ 1011-15.

²⁰ See Immunity Framework at 37 (describing a sunset provision encouraging policymakers to consider whether economic "conditions have changed such that the problem would not exist even in the absence of the immunity"); see also Statement of James C. Miller III Before the Antitrust Modernization Commission Hearings on Statutory Immunities and Exemptions 37 (Dec. 1, 2005)("I see little reason to hold onto any of these antitrust immunities/exemptions from a strictly economic standpoint . . . eliminating these immunities/exemptions would increase economic efficiency and better serve the interest of consumers.")

stakeholders may have opposing evidence and viewpoints that could enable decision makers to weigh the costs and benefits of the immunity.²¹ They could also present less restrictive alternatives to the proposed immunities. Statutory immunities often are not time limited, and thus may live well beyond their useful purposes in light of changing industry conditions. Congress does not often review statutory immunities to determine whether or not they have met their stated purpose. Finally, because of a lack of legislative history and clear record as to the underlying purpose of the immunity, courts have often expanded the scope of the immunity beyond its stated limit.²²

Unless Congress expressly states, after careful weighing of costs and benefits, the parameters of the immunity, the default rule should always be competition. It follows from the foregoing that antitrust “savings clauses” should not be required, given that immunities ought to be express and a detailed legislative history provided. A savings clause, in contrast to establishing competition as the default rule, places the burden upon Congress to actively declare (and re-declare) that the antitrust laws apply.²³ Immunities and exemptions have created such a large umbrella for conduct that even the mantra of antitrust savings clauses has little or no effect.

²¹ Congress is partly responsible because it “grants exemptions from antitrust that legalizes otherwise unlawful exploitative and exclusionary conduct without any comparable review of the projected costs or benefits of such statutes.” Statement of Peter C. Carstensen Before the Antitrust Modernization Commission Hearings on Statutory Immunities and Exemptions.

²² Immunity Framework at 35 (“In the context of antitrust immunities, legislation ostensibly reflects a policy judgment that immunized conduct would currently confer a net benefit to society.”). See Symposium: *Antitrust Boycott Doctrine*, 69 IOWA L. REV. 1165, 1173 (1984) (discussing the Realist movement and the “assumption that Congress was not clear about its intent when it enacted the antitrust laws”).

²³ “Antitrust clauses clearly preserve the applicability of the antitrust laws” by allowing “congress to consider, on a cases-by-case basis, whether to include an antitrust savings clause in particular pieces of regulatory legislation.” Statement of J. Bruce McDonald Before the Antitrust Modernization Commission Hearings on Antitrust and Regulated Industries.

Granting express immunity to post-and-hold regulations seems without foundation. Benefits to such regulations fail to appear, unless the abdication of state regulators from engaging in active regulation is somehow a benefit. Moreover, such post-and-hold regulations have substantial costs in terms of facilitating collusion without proper oversight, to the detriment of consumers. A less restrictive alternative which would achieve the goals states implementing such schemes seek would be to actively supervise liquor prices, not leaving such pricing points up to private actors not vested with a public interest.

Moreover, it is increasingly difficult, given the current state of state action doctrine, for parties to challenge unlawful conduct merely wrapped in the gauzy cloak of regulation. An express immunity would create a risk of immunizing behavior not intended to be shielded by the statute, thus shielding behavior that would injure consumers. Instead, states should be encouraged to design regulations that do in fact ensure that a regulator vested with a public interest is exercising oversight authority over any price scheme.

Finally, care should be given to determine the extraterritorial effects of state regulation of liquor and any conduct immunized by federal legislation. As is mentioned in the Federal Trade Commission's State Action Report, examination of state regulation via the lens of the "state action doctrine fails to account for the efficiency losses and the breakdowns in the political process posed by interstate spillovers."²⁴ In examining

²⁴ Report of the State Action Task Force: Recommendations to Clarify and Reaffirm the Original Purposes of the State Action Doctrine To Help Ensure That Robust Competition Continues to Protect Consumers, 39-40 (September 2003),

whether post-and-hold regulatory schemes are deserving of antitrust immunity, attention should be paid whether the conduct immunized impacts upon interstate commerce and in particular consumers of other states.